

The University of Chicago

THE FIXED INVESTMENT TRUST

A PART OF A DISSERTATION SUBMITTED TO
THE FACULTY OF THE SCHOOL OF BUSI-
NESS IN CANDIDACY FOR THE DEGREE OF
DOCTOR OF PHILOSOPHY

1937

By
MARSHALL D. KETCHUM

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PREFACE

During a decade characterized by rapid change, few financial institutions have experienced more rapid shifts in structure, policies, and popularity with investors than the investment company. In 1926 the management type investment company was a well-established institution in Great Britain but was just beginning to arouse interest in this country. Several American adaptations of the British type had also begun to evolve.

From 1926 to 1929 the numbers, capitalization, and resources of the management type company increased with extreme rapidity. It typified the "New Era" in the American securities markets. The American variations of the British institution were eclipsed.

With the inauguration of the bear market in 1929 there occurred a reaction against the management type which has not fully spent itself even today. Out of the maelstrom of the early months of the depression emerged the so-called fixed type company, a type distinctly American. From late 1929 to late 1931 companies with a fixed portfolio enjoyed as phenomenal a burst of popularity as had the management type during the boom. In 1932 and later this type declined as had its predecessor.

The years since 1933 have witnessed confusing trends. The investment company as a whole has remained quiescent. The fixed type has saved itself from extinction by changing its portfolio policy to one of semifixed, or restricted management. The use of shares of the fixed company as the investment medium for a new type of company, the systematic investment fund, has also helped it to carry on. Still another type, the mutual fund, which during the depression also benefited from the unpopularity of the management type, has been coming to the fore. As the recovery phase of the cycle progresses, the management type, showing some evidences of vitality, slowly regains some of its prestige. The most recent trend in the field has been the expansion of the fixed company and its adaptations in England, where 58 companies are at present in existence. This condition is even more surprising in view of the fact that much of the literature has attributed

the rise of the fixed type in this country to the differences in the policies of the British as compared with American management type companies.

In this study we shall examine the causes and progress of these shifts in popularity from one type to another. Emphasis will be placed upon the so-called fixed type in an attempt to determine the origin of this type and the causes and conditions which lead to its rise and decline.

TABLE 1
NUMBER OF INVESTMENT COMPANIES IN THE UNITED STATES AND
CANADA IN YEARS 1928-32 INCLUSIVE AND IN YEAR 1935
BY TYPES OF COMPANIES*

Type of Investment Company	1928	1929	1930	1931	1932	1935
General management.....	162	360	538	501	425	350
Fixed and semifixed.....	23	29	70	147	167	165
Systematic investment fund companies.....			3	13	16	27
Total.....	185	389	611	661	608	542

* The data for the years 1928-32 inclusive are from C. P. Keane (ed.), *Keane's Manual of Investment Trusts* (New York: Keane's Financial Publications, Inc., 1932), p. 11. The figures for the fixed and semifixed and systematic investment fund companies for the year 1935 are compiled by the writer from *Government and Municipal Volume; Investment Trusts, Real Estate Mortgage, Finance and Insurance Companies* (New York: Poor's Publishing Company, 1935), from *Manual of Investments (American and Foreign); Banks—Insurance Companies—Investment Trusts—Real Estate Finance and Trading Companies* (New York: Moody's Investors Service, 1935), and from the records of the Registration Division of the Securities and Exchange Commission, Washington, D.C. The data were compiled by adding companies in *Poor's Manual* for 1935, companies in *Moody's Manual* for 1935, and companies for which registration statements were in the files of the Securities and Exchange Commission, and subtracting duplicates and companies which other sources, believed to be reliable, indicated as out of existence or not in active operation. The 1935 figure for management companies is secured from *Moody's Manual of Investments* list on pp. a34-a36 of the 1935 volume, less companies included in the list which should be classed as holding companies and trading companies.

Let us examine the changes which have taken place in the relative importance of the various types of investment companies, based on degree of management. Comparison is made in Table 1 of the numbers in the United States of three types in the years 1928 to 1932 inclusive and in the year 1935, and Table 2 presents the percentage which each type bears to the total for each year.

The data in Table 2 show that, whereas the fixed and semifixed type of investment company constituted only 12.4 per cent of the total number in 1928, by 1932 the percentage of fixed and semifixed com-

panies and systematic investment fund companies to the total had increased to 30.1. By 1935 this percentage had increased to 35.5.

These data also indicate the importance, relative to the total, of the types of companies with which this study is primarily concerned—namely, those of the contractual type. We may at this point define briefly the contractual investment company as one which is brought into existence as a result of a contract or indenture between a depositor and a trust company. All of the fixed and semifixed companies and the systematic investment fund companies are of the contractual type. In

TABLE 2

PERCENTAGES OF INVESTMENT COMPANIES IN THE UNITED STATES AND
CANADA IN YEARS 1928-32 INCLUSIVE AND IN YEAR 1935
BY TYPES OF COMPANIES*

TYPE OF INVESTMENT COMPANY	PERCENTAGE OF TOTAL					
	1928	1929	1930	1931	1932	1935
General management.....	87.6	92.5	88.1	75.8	69.9	64.5
Fixed and semifixed.....	12.4	7.5	11.5	22.2	27.5	30.4
Systematic investment fund companies.....			.4	2.0	2.6	5.1
Total.....	100.0	100.0	100.0	100.0	100.0	100.0

* Compiled from data in Table 1.

addition, thirteen of the companies which have been included in the management group in the foregoing tables are contractual companies. Thus we may add this number to the 1935 figures for the fixed, semi-fixed, and systematic investment fund companies and determine the percentage of this total to the total of all companies. This percentage is found to be 38.0, and thus this study concerns itself with 38.0 per cent of all the investment companies in existence in the United States in 1935. To secure the grand total of companies covered by this study we may add to the foregoing total for the United States and Canada 58 companies in Great Britain and 4 companies in continental Europe. This makes a grand total of 267.

The companies in Table 1 which are not of the contractual type are

different in legal form, most of them coming into existence as a result of incorporation. A few of the noncontractual type are not incorporated but are organized under the common law or Massachusetts trust laws of some states. Such companies, while not incorporated, are not of the contractual type. From a legal standpoint, the incorporated companies and those which are unincorporated but which are not of the contractual type may be designated as of the direct or statutory type.

Our interest in the contractual type company is prompted by several considerations. In the first place, it is the most recent large-scale development in the investment-company field. While but little new long-term financing has been carried on by the direct type company since 1930, approximately one billion dollars worth of financing has been undertaken by companies of the contractual type since that year. Secondly, inadequate attention has been paid to the contractual type in the literature on the investment company. The recency of the growth of this type is one cause for this. Several good works on the investment company in general were published before 1930, but since the contractual company was unimportant before that year, the treatment of this type was brief and incomplete. Walter N. Durst's book¹ which appeared in 1932 devoted a considerably larger proportion of space to this type, but many important developments have occurred even since 1932. This is the first study which has been made exclusively of the contractual type investment company.

¹ *Analysis and Handbook of Investment Trusts* (New York: Rand-McNally & Co. 1932).

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CHAPTER I

THE INVESTMENT COMPANY IN GENERAL

Several authors have devised satisfactory definitions of the investment company. Leland Rex Robinson gives the following definition:

An investment trust . . . is an agency by which the combined funds of different participants are placed in securities showing a distribution of risk such as to introduce the "law of average" in protection of the principal; and which aims solely at the safe and reasonably profitable employment of the subscribed investment funds while definitely avoiding any and all of those responsibilities of control, management, finance, direction or special interest which are sometimes tied in with investment.¹

Construing the word "safe" broadly, we may accept this definition as adequate. Fowler states that "the investment trust may be defined as an organization for the collective investment of numerous individuals in numerous securities."² Grayson³ emphasizes the feature of diversification of the securities in the portfolio of the company, with consequent spreading of the risks to the benefit of the investor. Steiner⁴ points out that the investment trust is an agency which combines the funds of many investors, applying the funds to the purchase of many securities for investment only. These statements indicate the fundamental features of the institution which we are studying.

It is necessary at this point to consider our reasons for the use of the term "investment company" as contrasted with the term "investment trust." All the above-mentioned authors use throughout their works the term "investment trust." It is almost universal in popular discus-

¹ L. R. Robinson, *Investment Trust Organization and Management* (Rev. ed.; New York: Ronald Press Co., 1929), pp. 13-14.

² J. F. Fowler, Jr., *American Investment Trusts* (New York: Harper & Bros., 1928), p. 20.

³ See T. J. Grayson, *Investment Trusts* (New York: John Wiley & Sons, Inc., 1928), p. 1.

⁴ See W. H. Steiner, *Investment Trusts, American Experience* (New York: Adelphi Co., 1929), p. 2.

sions even today to refer to the institution as an investment trust. Why do we consider it necessary to make such a radical departure from popular usage?

Let us first examine the origin of the term "investment trust." This institution as we know it today first appeared in England in the early 1860's. At this time the corporation laws of Great Britain had not yet been consolidated into the Companies Acts, under which chartered companies are organized in England today. These early associations were consequently unincorporated. They were of a voluntary nature and were fiduciary in character. Because of the legal method used in their formation they became known as "trusts."⁵ It is true that the first of the Companies Acts⁶ was passed in 1862 whereas the first investment companies in England, the London Financial Association and the International Financial Society,⁷ were not organized until 1863. However, it was some time before incorporation under the Companies Acts became common. It was necessary to clarify the original act by eighteen subsequent acts of Parliament between 1862 and 1908.

After the inauguration of the investment company in England and Scotland, progress was slow for some years. By the time the movement began to gain momentum, the Companies Acts were sufficiently well formulated so that the companies used this legal device in organizing. But by that time the term "investment trust" had taken root and the change in method of organization could not dislodge it, although more recently the institution has come to be known in Great Britain as the investment trust company or the investment-trust company. In view of the changed method of organization, the term "investment trust" came to have no legal significance. The companies do not carry out the functions of a trustee in the legal sense and they are not restricted by law in the selection of investments. A few of them have acted as actual trustees under corporate mortgages, as secretaries of allied enterprises, and as registrars for stock and bond issues,⁸ but

⁵ See Grayson, *op. cit.*, pp. 1-2.

⁶ Officially cited as 25 and 26 Vict. c. 89: "An act for the incorporation, regulation and winding up of trading companies and other associations, adopted August 7, 1862."

⁷ See Grayson, *op. cit.*, p. 14.

⁸ See letter from Morgan, Grenfell & Co. of London as quoted in Grayson, *op. cit.*, p. 89. See also Steiner, *op. cit.*, p. 4.

these activities are negligible. Thus it came about that the term "investment trust" had an economic, but not a legal, connotation.

When examples of this financial institution began to appear in the United States in the post-World War period, the name, as well as the idea, came from England. However, the dominant legal method of organization from the first was incorporation under the state general enabling acts. Up to this time the word "trust" had generally been used by bankers and lawyers to denote a fiduciary relationship and as something to be regulated by law.⁹ During the decade of the twenties some opposition developed to the use of the term. It was thought that it might have the tendency to cause the public to confuse this type of institution with the trust company. It was also thought possible that use of the term might lend the impression that the directors of the investment company were in a fiduciary position as trustees of the funds obtained through the sale of investment-company securities. Steiner, on the other hand, states that "the word 'trust' is useful in that it emphasizes the responsibility which devolves upon the management of the trust. They are in many ways trustees for the investors who entrust their money to them rather than merely directors of a corporation."¹⁰ We have been unable to find any decisions which would give the impression that directors of a corporation stand in a strictly fiduciary relationship to the stockholders.

The opposition to the use of the word "trust" in informed quarters led finally to action by the Investment Bankers Association in an attempt to discourage the use of the term. The official title of the committee of the Investment Bankers Association dealing with this institution became "Investment Companies Committee." The 1928 report of this committee cited the fact that the use of the word in connection with the investment-company movement is unfortunate and should be abandoned as misleading. No strictly fiduciary relationship exists, since the buyer of the stock of an investment company is as a buyer of stock in any other company. The owner of stock takes his chances as to losses as well as profits. He is not a beneficiary of a trust administered for his benefit any more than is any stockholder in any

⁹ See A. A. Winston, "Branches of Investment Trust Growth," *Forbes*, November, 15, 1928, p. 90.

¹⁰ Steiner, *op. cit.*, p. 5.

corporation who receives a benefit from its operation and conduct. It is true, of course, that the beneficiary under a trust also takes risks, but the courts usually require a greater degree of care on the part of the trustee than of corporate directors. The investment company is a transplantation from England where the trusteeship is at least implied, but such relationship is not even implied in this country.¹¹

The use of the word "trust" has been still more unfortunate in view of the fact that in this country the term "investment trust" has been extended to include many types of companies which are not only not "trusts," but are not even organized for the purpose of "investment" in the orthodox sense of the word. The dangers involved in the application of the term to those companies formed with the idea of acquiring control of other companies or for the purpose of taking advantage of possibilities for quick trading profits in the stock market were brought out in the 1929 report of the Investment Companies Committee of the Association.¹²

Governmental agencies exercise no direct jurisdiction over the investment policies of investment companies, as is the case with the investments of trust companies, savings banks, and insurance companies.¹³ The only requirement is that the portfolio be in accordance with the powers of investment given to the company under its charter. As a rule, trust investments usually consist of so-called high-grade securities, whereas a large percentage of the value of the portfolios of most investment companies, particularly in this country, is in the form of common stocks.

¹¹ See the report of the Investment Companies Committee of the Investment Bankers Association for 1928 in *The Commercial and Financial Chronicle*, December 15, 1928, pp. 3300-3301. See also *The Commercial and Financial Chronicle*, November 2, 1929, p. 2757.

¹² See the report of the Investment Companies Committee to the eighteenth annual convention of the Investment Bankers Association, October 16-18, 1929, as given in *Keane's Investment Trust Monthly*, May, 1930, p. 235.

¹³ In 1929 the trust companies in New York City registered their objection to the use of the term "investment trust." See on this point J. S. Richards, "The Investment Trust Study of 1936," *Barrons*, May 4, 1936, p. 8. This article indicates the nature of the problems facing the Securities and Exchange Commission in the 1936 investment-company investigation, particularly with regard to the necessity of deciding what an "investment trust" is before the Commission is in a position to choose those companies to be included in the study.

Another evidence of effort to change the terminology is found in the Investment Bankers Code of Fair Competition, approved March 23, 1935, under the terms of the National Industrial Recovery Act of 1933. Article VIII, Section (e) of the Code states:

Such investment banker (who has agreed to manage or give advice to the management of an investment company) shall use his best efforts to cause the investment company not to use the term "trust" as part of the title of such investment company unless the use of the term "trust" is justified as a matter of law.¹⁴

A few writers of books in the field of banking and finance in recent years have adopted the term "investment company," although a majority still adhere to the more popular usage. The most recent book in the investment-company field, Durst's *Analysis and Handbook of Investment Trusts*, published in 1933, uses the terms "investment trust" and "investment company" interchangeably. Durst points out that:

The older term, investment trust, has indicated to some a connection with a trust company although this is seldom the case. "Investment company" aptly describes the majority of these organizations, although many are technically "trusts." The term "investment trust" has long been used to describe these organizations and is the more generally common term, its use having been established in Great Britain and Scotland for decades. It has become the generally used term in the United States, with the use of the term "investment company" more common during recent years.¹⁵

It has been indicated that practically all investment companies of the management type in Great Britain are now organized under memoranda of association and that a larger percentage of the companies in this country are organized as corporations under state charters. A number of variations in legal method of formation, however, have been evolved in this country. A few of the direct type are organized as statutory common-law trusts, Massachusetts trusts, or "business trusts." This organizational device first came into general use in Massachusetts where the state incorporation act originally forbade corporations chartered in Massachusetts to hold real estate. Another

¹⁴ *Code of Fair Competition for Investment Bankers* (Washington: Government Printing Office, 1934).

¹⁵ Durst, *op. cit.*, p. 2.

variant in legal method of organization is the contractual company. The essential feature of this type is that it is brought into existence by a contract between a depositor and a "trustee," in which it is provided that certain securities are deposited with the "trustee" to be held for the benefit of the holders of certificates representing pro rata interests in the deposited funds. Thus individual trustees are used in bringing into being the common-law trust, a subtype of the direct type, while an institutional trustee is used in organizing the contractual type. It is desirable to avoid the use of the term "trust" with this group, in spite of the fact that trustees are involved.

Concerning the common-law trust, the case is not so clear against the use of the term as in those cases where the company is incorporated. The firm is organized under a declaration of trust, a trust agreement, or an indenture. Rights in equity generally attach to the beneficiaries, or the share or certificate holders (*cestuis que trustent*), requiring of the trustees faithful performance of their duties. Legal title to the securities generally rests with the trustees. In any event, the total of statutory common-law trusts as compared to the total number of direct type investment companies is small and it would not be justifiable to call the entire group "investment trusts" because a few are organized as true trusts.

The essential feature of the trustee relationship is the distinction between the resting place of the legal title and of the equitable title to the property. The trustee relationship involves the control over property by a trustee, legal title resting with him. In the case of corporate securities constituting the trust property, the securities are registered on the books of the corporation in the name of the trustee or the corporation is entitled to recognize the trustee as legal owner of the securities. The trustee, however, must administer the trust property (legally the trust *res*) for the benefit of the true owners (the *cestuis que trustent*) in whom the equitable title rests. The principles of equity govern the responsibility of the trustee to the owner of the property in equity.

Let us now examine the legal structure of the contractual type company and see to what extent the trustee relationship is involved. Investment companies of this type, as has been indicated, exist by reason of a contract. This contract generally involves three parties: (1) the creator of the "trust," generally known as the depositor, (2) the

"trustee," generally a trust company or the trust department of a commercial bank, which holds the portfolio of the company, and (3) the owners of the participating certificates, who, by the act of buying these certificates, become *ipso facto* parties to the contract under which the certificates are issued. Thus it is seen that an institutional trustee is involved in the sense that it has possession of the property of the company. However, possession of the property does not necessarily signify legal title to the property. A number of companies of the direct type have executed "custodian agreements" with trust companies by which securities purchased for the portfolios are deposited for safe-keeping with a trust company, but legal title remains with the corporation, or with the individual trustees of a business trust. Custodian agreements of this sort do not create a trust because legal and equitable titles to the property rest in the same agency.

What is the situation with regard to the contractual company in this connection? Where do the legal and the equitable titles to the deposited property lie? On this point depends our answer to the question of whether or not the contractual type company is actually a trust. We find that legal title never rests with the depositor. This reduces the question to the "trustee" and the certificate-holders. Possession, we have seen, rests with the "trustee." If legal title also rests with the "trustee," equitable title being in the hands of the certificate-holders, a legal trust has been established; if both legal and equitable titles are in the hands of the certificate holders, no common-law trust has been formed, but rather a deposit agreement has been executed.

An examination of the indentures or contracts under which contractual companies are formed shows that most of them provide that legal title, as well as possession, shall rest with the trustee. There is always found in the indenture setting up the company a clause containing a statement covering the question of the party in whose name the securities are to be registered. The following is a good example of such a provision: "Upon each deposit of stock or other securities under this Agreement, the certificates therefor, unless by their terms in bearer form, shall be registered in the name of the Trustee or its nominee or nominees. . . ."¹⁶

¹⁶ *Trust Endowment Shares, Series "A" and "AB,"* trust agreement between Corporate Equities, Inc., sponsor, and the First National Bank of Jersey City, successor trustee, January 1, 1933, art. i, sec. 5, p. 4.

This situation is generally found in the unit type company, more commonly known as the "fixed" type company.

Thus it is found that most contractual type companies make use of the trustee device. But this situation is not universal. It is possible for a contractual company to be so organized as to vest legal title, as well as equitable title to the investment fund in the certificate-holders. A few companies so organized call themselves trusts whereas actually they are not trusts but are brought into existence through the execution of a deposit agreement or a custodian agreement. A good example of this situation is found in the case of Diversified Trustee Shares, Series "B," whose indenture affirms that "[legal] title to the deposited stocks and securities shall vest in the respective certificate holders in proportion to their holdings of certificates."¹⁷ A provision having the same effect is found in the indenture creating Diversified Trustee Shares, Series "C." The clause reads as follows:

Notwithstanding the registration of the stock in the name of the trustee, or its nominee, and the designation throughout this agreement or in the certificates of the depository of the stock and/or securities, as the "trustee," the absolute ownership of all stocks, securities and/or property deposited hereunder shall be vested in the respective certificate holders in proportion to their holdings of certificates, and nothing herein shall be deemed to or in the certificates contained shall be deemed to create any trust in the trustee or in the depositor in said deposited shares, securities and/or property.¹⁸

In addition, a number of contractual type companies, particularly of the fund type, do not vest legal title to the fund with the "trustee" and do not call themselves trusts. The contract by which such a company comes into existence is known as a custodian agreement or a depository agreement, and the trust company which acts as depository for the investment fund is called the custodian rather than

¹⁷ *Diversified Trustee Shares, Series "B,"* trust agreement between American Trustee Share Corp. and Chatham-Phenix National Bank & Trust Co., as quoted in Fowler, *op. cit.*, p. 70.

¹⁸ *Diversified Trustee Shares, Series "C,"* trust agreement between American Trustee Share Corp., depositor, and Chatham-Phenix National Bank and Trust Co., trustee, September 5, 1929, art. ii, sec. 1, p. 19, as quoted in R. D. Kilbourne, *Principles of Money and Banking* (New York: McGraw-Hill Book Co., 1932), p. 535.

the "trustee." As an example the prospectus of Keystone Custodian Funds, Inc., states that:

The securities and cash comprising these Funds are received and held by The Pennsylvania Company for Insurances on Lives and Granting Annuities, as Custodian. Custodianship by a bank provides a protection similar to a personal safety deposit box.¹⁹

In some cases, particularly in certain types of investment contract plans, a specific contract is executed between the manager of the fund and each investor. Under such an arrangement no trust relationship is created, but rather one of principal and agent. For example, the contract setting up a mutual custodian account between Economic Analysts, Inc., as investment manager and the owner of an account, as the principal, states that:

. . . . It is expressly understood and agreed by and between the parties hereto and each of them that it is their intention, by becoming parties to this Contract, to create only the relationship of agents and principal between the Custodian and Investment Manager (as agents) and each Principal and that the Principals hold no relation to the Custodian and the Investment Manager other than that of Principals and hold only such rights subject only to such obligations as are conferred or imposed upon them as such Principals hereunder.²⁰

In this type of company the investor becomes the principal, the manager of the investment fund is his agent for the investment of the funds and the custodian is his agent for the safe-keeping of the invested funds.

Collateral Equities Trust Shares justifies its use of the term "Trust Fund" as follows:

. . . . The Trust Fund is supervised by the Depositor's Investment Committee, and the function of supervision has been surrounded with safeguards embodied in the Trust Agreement in order that flexibility may be possible without sacrifice of reasonable safety. Such a trust relationship differs essentially from a custodianship. The former implies the safeguards of a

¹⁹ *Keystone Custodian Funds, Inc.* (general prospectus), April 22, 1935, p. 2.

²⁰ *Mutual Custodian Accounts*, contract between Economic Analysts, Inc., investment manager, and owners of custodian account, art. xxii, sec. 4, p. 20.

Trusteeship under supervision, while custodianship is the mere holding of property for another without a true trust relationship.²¹

It will be noticed, however, that in this case the depositor exercises the function of supervision, rather than the agency which holds legal title to the property, as is the case with the usual type of trust.

To summarize, we find that, of the direct or statutory type, most companies are corporations and therefore not trusts, while a few are organized as statutory common-law trusts, and may properly be called trusts. Of the contractual type companies, most call themselves common-law trusts, while some do not. Of the group which call themselves trusts, most actually are trusts, but a few are not. Thus not all statutory type companies are corporations, and not all contractual type companies are trusts. But there is no reason why all cannot be called companies. The word "company" can be used in this sense simply as a business unit or a group of individuals associated together to accomplish some mutually agreed purpose, whatever legal form the organization may take.

The word "trust" should not be applied to the contractual company, even though a majority are actually common-law trusts. Even if all contractual companies were trusts, the use of the term would still be inadvisable, since it would be likely to be confusing to the investing public, whereas no misrepresentation is involved in the word "company." The term "trust" brings to mind legal control by trustees over investment policy; there is no such control over the investments of the contractual company. In most true trusts the trustee has considerable control over the trust fund and often a great deal of managerial discretion in the administration of the fund; in the contractual company the "trustee" has very little control over the fund and his discretionary powers are extremely limited. Most trust funds are invested in high-grade securities; most contractual company funds are invested largely in common stocks. Many duties and liabilities ordinarily assumed by an institutional trustee are specifically not assumed by the custodian for the contractual company.²²

²¹ *Collateral Equities Trust Shares* (prospectus), ca. June, 1935, p. 1.

²² For a further exposition of the incorrect terminology under consideration here see R. D. Kilbourne, *op. cit.*, pp. 534-35. For a discussion on the nature of a trust see N. G. Riddle, *The Investment Policy of Trust Institutions* (Chicago: Business Publications Co., 1934), p. 2.

Consequently, because not all contractual companies are trusts, and where they are trusts the "trustee" often does not assume the usual trustee functions, the word "company" will be used in place of the word "trust" in this study, and the term "custodian" will be used for "trustee." The term "custodian" is much more likely to give a correct understanding of the principal duty of this agency in the contractual company, namely, the safe-keeping of securities. We shall use the word "trustee" only when referring to a specific company which uses this term in describing itself. In the same way, the document which is often called a "trust indenture" or "trust agreement" will be known in this study simply as an indenture, an agreement or a contract.

It is desirable at this point to set up a comprehensive classification of investment companies in order that we may secure a view of the entire investment-company field and in order that we may be in a position to see the principal points of similarity and contrast between the group of investment companies which we shall be studying and other groups. Investment companies can be classified:²³

I. According to the legal method of organization

- A. Contractual type (indenture type). This type comes into existence as a result of a contract or legal agreement to which the participants are parties.
- B. Statutory type. This type comes into existence as a result of organization under the statutes of a political entity, or, in a few cases, under court decisions and common-law principles as modified by statutory enactments.

II. According to the nature of the securities issued

- A. Indirect type. Shares issued represent a pro rata share in specific property deposited with a trustee or custodian. Most contractual companies are of this type. Shares are redeemable or convertible.
- B. Direct type. Shares issued represent an equity in the corporation, but not in any specific property. All are of the statutory type. Shares are generally not redeemable or convertible.

²³ The basic distinctions made between the contractual type and statutory type companies as indicated in the classification follow the distinctions made by Robinson in his *Investment Trust Organization and Management*. See chap. ii of this work, pp. 31-48. Acknowledgment is also made for a few features in the outline to a classification of investment companies by E. D. Allen in *A Statistical Analysis of Investment Trusts*, an unpublished Master's thesis, University of Minnesota, 1933.

- III. According to the division into groups of the property held
 - A. Unit series type (unit type). The property held is divided into units, all of which are alike. On the basis of each unit participating shares are issued. All are of the contractual type.
 - B. Fund type. The portfolio is not divided into units but constitutes a fund. All companies of the statutory type and all companies of the contractual type except those of the unit series type may be said to be of the fund type. The term is generally reserved, as will be done in this study, for those contractual type companies which are not of the unit series type. Certificates issued represent proportionate claims against the entire fund.
- IV. According to the exercise or nonexercise of management
 - A. Fixed type (rigid, nondiscretionary or static type). It is intended that the portfolio originally established shall not be changed except upon the occurrence of an event decided upon in advance and set forth at the time of establishment of the portfolio. Elimination provisions are mechanical. No substitutions are permitted. All are of the contractual type.
 - B. Semifixed type (supervised type). It is intended that the portfolio originally established shall remain unchanged unless conditions change to such an extent that a change appears advisable. Eliminations are discretionary. Substitutions may or may not be permitted. Most are of the contractual type.
 - C. Restricted management (semimanagement type). It is not intended that the portfolio originally established shall remain unchanged, but those vested with the authority as to changes are hedged about with more or less complete restrictions as to the scope and frequency of changes. It is expected that changes will take place more often than in IV, B. Substitutions are permitted and are usual. Most are of the statutory type.
 - D. Pure management type (general management type). It is expected that the portfolio will be changed as changes in the long-time investment outlook appear, including changes which are necessary to adjust for business-cycle conditions. There are very few restrictions on the management. Substitutions are permitted and are usual. Most are of the statutory type.
- V. According to the nature of the portfolio
 - A. According to the types of property which may be placed in the portfolio
 - 1. Corporate securities
 - a) Bonds only (a few contractual companies and a few statutory companies)

- b) Stocks only (most contractual companies)
 - c) Both bonds and stocks (most statutory companies)
 - 2. Noncorporate securities (relatively unimportant—a few contractual companies)
 - a) Government securities
 - b) Oil-royalty interests
 - c) Real estate deeds
 - d) Miscellaneous
 - B. According to the number of industries which may be represented in the portfolio
 - 1. General. No restrictions on number of industries and only minor restrictions on the types of industries. Nearly all statutory companies and most contractual companies.
 - 2. Specialized. Only securities representative of a particular industry are permitted in the portfolio. A few statutory companies and many contractual companies.
 - C. According to the geographical diversification represented in the portfolio
 - 1. Companies holding securities originating anywhere. A few contractual companies and many statutory companies.
 - 2. Companies holding securities originating only in the country in which the investment company is organized. Nearly all contractual companies and most statutory companies, particularly in the United States.
 - 3. Companies holding securities originating only in a particular section of the country. A very few statutory companies of this type; none of the contractual type in existence at present.
- VI. According to the types of securities issued
 - A. Those issuing shares only
 - 1. One type only. Nearly all contractual companies and many statutory companies.
 - 2. Class A and B common, and/or preferred shares. A few contractual companies and many statutory companies.
 - B. Those issuing shares and obligations, “trading on the equity.” Many statutory companies. No contractual companies.

In the foregoing classification we have indicated the relative importance of contractual companies and statutory companies in each item in order to indicate the characteristics of those companies with which we are primarily concerned in this study. Summarizing, we find that the characteristics listed under the following headings are most im-

portant from our standpoint: I, A; II, A; III, A, and III, B (see note); IV, A, and IV, B; V, A, 1a, and 1b; V, B, 1, and B, 2; V, C, 2; and VI, A, 1.

The authors of the standard works on the investment company do not agree wholly in their classifications of investment companies, but their differences are more in the use of terms to describe investment-company types than in matters of disagreement upon fundamental points. Steiner (chap. IV, *Investment Trust Types*, pp. 70-84) distinguishes between the corporate type and the fund type. He divides the fund type into four groups, as follows: (1) a fund created and operated by trustees, (2) a fund created by a concern which manages it, (3) a fund invested in an initial list of specified securities and created by a concern which manages it, and (4) a fund invested in a fixed list of securities deposited by a concern which creates it. Steiner's corporate type is similar to the statutory type in our classification which are organized as corporations and his first-named fund type is equivalent to the statutory type companies which are organized under the common law as Massachusetts or business trusts. The second, third, and fourth of Steiner's fund type companies are of the contractual type and Steiner indicates that this term is sometimes applied to them.

The New York State Department of Law in its 1927 report on *Investment Trusts* ("A Survey of the Activities and Forms of Investment Trusts with Recommendations for Statutory Regulation by the New York State Department of Law") offered a classification of investment companies based particularly on the degree of supervision exercised over the portfolio. The report divided investment companies into those of the management type and the fixed or limited management type.²⁴ Those of the management type were subdivided into general and specialized investment companies.²⁵ The classification into management investment companies corresponds to items IV, C and D, in our classification while the fixed or limited management company is found in items IV, A and B. The report's use of the terms "general" and "specialized" is the same as that in V, B.

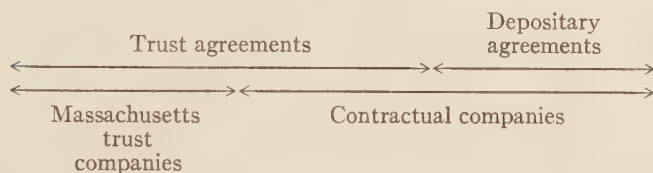
Grayson's classification is based upon the division of investment companies into four types, the corporate form, the business or Massa-

²⁴ See Appendix 2 of the report, pp. 124-30.

²⁵ The report uses the term "trust" rather than "company."

chusetts trust, the investment fund trust, and the bankers' share company. The first two of these types we classify as "statutory" and the last two as "contractual."²⁶

In the use of the term "contractual" it should be remembered that not all contractual companies are trusts, since some are organized under depositary agreements. In addition, not all trusts are of the contractual type, since Massachusetts trusts are common-law trusts, yet they are classified as of the statutory type. This situation may be made clear by the following diagram:



Uniform funds, a term applied especially to companies which are formed by trust companies to enable their clients to share in jointly operated trust funds in round minimum amounts too small to warrant an individual trust estate, may take either the trust form, in which case they should be classed as contractual companies, or the corporate form, in which case they are of the statutory type. There is a tendency toward the use of the incorporated form of organization. No public participation is involved, however, since in this type the investment corporation is merely a convenient device employed by the trust officers for investment of the corpus of any trust estate committed to their charge, when permission to make such investment is granted by the testator.²⁷

No mention has been made in the foregoing classification of the mutual fund type of company. The mutual fund company may be either a contractual or a statutory company, although most of them are of the latter type. If it is a contractual company it is always of the fund type. If it is a statutory company it may be organized as a corporation or as a common-law trust. It follows the general char-

²⁶ See Grayson, *op. cit.*, pp. 146-51.

²⁷ See L. R. Robinson, "Classification of Investment Trusts," *Keane's Investment Trust Monthly*, April, 1930, pp. 186-87.

acteristics of the statutory type in that it undertakes continuous management of the portfolio but it has also several important characteristics of the contractual type—namely, that sales of shares take place continuously, that the shares can be redeemed or converted at any time and that the prices of the shares on the market are based upon the underlying value of the assets of the mutual fund. This type of company has assumed considerable importance in recent years. With the reaction from the fixed type, companies providing for management of the portfolio have increased in popularity, but the public continues to prefer an investment providing for redeemability of the shares at the option of the investor and this is a feature which is not offered by the ordinary incorporated investment company. The mutual fund type company, however, provides both continuous portfolio management and continuous redeemability of shares. In addition, shares of the mutual fund type can be created and sold continuously, a feature which makes this type attractive to the investment-banking fraternity.

Table 3 summarizes the situation with regard to the number of companies included in this study.

TABLE 3
CONTRACTUAL TYPE INVESTMENT COMPANIES
IN EXISTENCE IN 1935

	UNIT SERIES			FUND			Sys. IN. F.	TOTALS
	Gen.	Spec.	Total	Gen.	Spec.	Total	Total	
United States.....	65	45	110	44	11	55	27	192
Canada.....	12	1	13	0	0	0	0	13
Great Britain.....	38	17	55	3	0	3	0	58
Continental Europe.....	2	2	4	0	0	0	0	4
Total.....	117	65	182	47	11	58	27	267

CHAPTER II

HISTORY OF THE CONTRACTUAL TYPE INVESTMENT COMPANY

We shall not undertake an extensive account of the history of the direct or statutory type investment company, since this phase of the subject has been adequately treated elsewhere. It will be sufficient to give only enough of the historical background to show the place of the fixed or contractual type company in the total historical situation.

The date of organization of the first true investment company is in dispute. Some writers give first position to a company organized in Brussels in 1822, the *Allgemeene Nederlandsche Maatschappij*, which, after the separation of Belgium from the Netherlands, was known as *Société des Pays Bas* and later as the *Société Générale de Belgique*.¹ This company was intended originally to facilitate small investments in foreign government loans which then offered more security and returns than home industry. Later it became interested in coal, iron, and other industries and gradually assumed the functions of a finance company. The first companies to be formed which all writers are agreed were investment companies were the International Financial Society, Ltd., and the London Financial Association, both organized in London in 1863. The growth of the movement was slow at first, but a considerable number of companies were organized in the late 1880's.

A number of circumstances rendered the time propitious for the growth of investment companies. Interest rates in Great Britain were abnormally low. British consols were on a $2\frac{1}{2}$ per cent basis and good bonds generally did not yield more than 3 per cent. Investments at higher yields were available on the Continent, incidental to the economic rise of the German Empire and the industrial renaissance in France. British capital was in demand for the execution of English imperial policy. The United States and South America, particularly Argentina, were expanding rapidly. The small British investor, grown

¹ See Egon Kilgus, *Kapitalanlagegesellschaften* ("Investment Trusts") (Berlin: Wilhelm Christians Verlag, 1931), p. 148.

cautious after the orgy of speculation which had wiped out the savings of British workmen in the 1820's and 1830's, mistrusted his own judgment in seeking lucrative foreign investments.

The investment company emerged from the practice of private trustees in handling large estates. Certain men in England became skilled in investing funds of individuals by setting up trust accounts and in handling the funds according to the specific needs of the beneficiaries. Certain principles and laws of trusteeship developed out of trust-company experience and from the experience of private trustees. The investment company originally was essentially an amassing of trust accounts into one large fund and the application of trust principles to the handling of a total fund. The problem of handling many accounts was much simplified by this procedure. The trustee could spend his entire time looking after the investments rather than having to bother with the many mechanical details of administration necessary in handling separate trust accounts. Although the early British companies soon turned from the trust form to the corporate method of organization, the spirit of trusteeship remained. Investment company shares did not come to be regarded generally as speculative media until the development of the institution in the United States during the 1920's.

By the end of 1890, fifty-five companies were in existence in Great Britain. After the period of retrenchment from 1890 to 1895, the numbers increased gradually until at the present time there are about two hundred companies of the management type in operation.

The development of the investment company occurred much later in this country. While the first company was formed as long ago as 1904 and some companies organized previous to that year had investment-company attributes, at the outbreak of the World War there appeared to have been but three small companies in operation. The movement in this country did not gather headway until 1924. From 1924 to the end of 1927, 165 management companies were formed, making a total of 190. At the end of 1929 this number had increased to 484, 121 being formed in 1928 and 173 in 1929. The capital funds raised by 1929 amounted to about five billion dollars. Since 1929, a few failures and a considerable number of mergers have led to a decrease in the number of management companies.

Several factors account for the rise of the management investment company in the United States after the World War. There was considerable agitation, political and otherwise, for the use of this device as a means of facilitating the export of capital. The Edge Law was passed in 1919 with this thought in mind. The export of capital, however, never became a primary motive in the development of the investment company. On the other hand, the sale of Liberty Bonds which took place during the war introduced large numbers of American citizens to the technique of security purchasing. Large accruals of capital were available for investments and large profits and high wages were creating an important new group of prospective investors. The prevalence of the corporate form of organization had made available large quantities of securities for purchase and sale and the organized securities markets had developed to facilitate this process. Americans generally were not in the mood to accept the conservative yields of seasoned bonds, since the rise in prices and in corporate earnings had lessened the attractiveness of fixed yields. On the other hand, the new investors felt unequal to coping with the large array of offerings.

As the speculative boom of the 1920's progressed, the investment company became more and more identified with it. The common stocks of management companies came to be used as a speculative medium by many of the new mass of citizens who were just being introduced to the intricacies of security speculation, although these individuals called their purchases of investment-company shares, as might be expected, "investments." The dangers inherent in the rapid growth of the investment company were not neglected by all commentators. The 1928 report of the Investment Companies Committee of the Investment Bankers Association contained a statement which since 1929 has had more attention paid to it than was given at the time it appeared:

It is perhaps unfortunate that these investment companies have sprung up among us in a period of inflated credit and boom prices on the Exchange. While they have a place in our financial affairs if properly conducted within limited areas of investing, they must be affected by the conditions now environing the issuance of stocks and bonds, and they should be approached with caution by the investing public.²

² *Commercial and Financial Chronicle*, December 15, 1928, pp. 3300-3301.

It was during the latter part of the decade of the 1920's that the term "investment trust" began to be applied to almost any company which purchased the securities of other companies, for whatever purpose. A great deal of confusion arose between the investment company, the holding company, the financial company, and the trading company. A statement in the *Commercial and Financial Chronicle* for December 7, 1929 (p. 3529), was prophetic:

The divergence of policies of the two types of finance company (trading corporations and investment companies) should be remembered so that the errors of the trading corporations are not charged to the investment trusts at a later day when the inevitable break-up in values occurs and investigations and legislative restrictions follow.

Whenever there is a period of intense and prolonged speculative excitement some new type of security generally develops and to it the public rushes in the quest of fortune. The trading corporation was the vehicle on which the public in 1929 started out on its ride to riches. Never in the history of any country had one kind of stock been so abundantly supplied. The stocks of trading companies, many of which were known as "investment trusts," overshadowed every other type of security. During the first nine months of 1929 domestic corporation bonds, notes, and stocks to the amount of \$8,661,228,272 were issued and sold in the United States. Of this total "investment trusts" accounted for over 25 per cent, or \$2,239,783,064. About 60 per cent of this latter figure was issued during the months of July, August, and September, 1929. A large percentage of this amount was not issued by investment companies proper, but by trading companies.

In many respects it is not justifiable to charge the investment company with the unfortunate results of these conditions and part of the disrepute into which it has fallen is unwarranted. The investment companies made mistakes, to be sure, but the real excesses occurred in the trading-company field, not among the investment companies. During 1928 and 1929 many investment-company executives pointed out that trading companies should not be confused with the type of company with which they were connected. Even the great majority of trading companies deprecated the use of the term "investment trust" in describing them and some pointed out the differences between the two types in their reports. The public, however, with its notorious

inability to differentiate, went on blithely calling everything an "investment trust." A large part of the disrepute and loss of prestige which the management investment company has had to bear, however well deserved, has not been caused by its own sins.

A financial writer in the *Commercial and Financial Chronicle* for December 7, 1929 (p. 3529), characterized the current popularity of the trading company as follows:

I may be doing an injustice to trading or financing companies as a class, but seeing the constant birth of them—almost a daily litter one might say—it has seemed as though they were conceived to meet a demand for a personally conducted tour of the small investor into the broad avenues and the by-paths of Wall Street. I doubt if they have a permanent place in the business of investing in securities or that they will survive the next prolonged period of declining prices. Consequently, I do not see how damaging deflation of their common stocks can be avoided.

There may be a place in our financial system for the trading company, but it should be known for what it is, and it should not be known as an investment company.

It must be admitted, however, that the management investment company offers a convenient medium for the activities of corrupt or inefficient managements and promoters and for the use of principles which are not in accordance with investment-company theory. This is largely because the investors in the nature of the case give wide discretionary powers to the managers, and, where reports are issued infrequently or with incomplete information, they do not know where their funds have been placed nor how often they have been shifted from one security to another.

The management investment companies formed in 1928 and 1929 were organized, of course, at the wrong time, since the managements were unable to adjust the portfolios for the impending decline in security prices. However, investment companies must be formed and must sell securities when the public demands securities and the public always demands equity securities when prices are high. Investment companies of all types are relatively easy to organize and consequently it is probable that in the future they will be organized when a demand for their shares exists, which means that they will continue to be organized at the wrong time. This is particularly true since it is

principally the small investor who purchases investment-company shares and it is the small investor who is most likely to buy at the top and sell at the bottom. These statements apply both to the management type and the fixed type investment company. Again, however, the investment company cannot be blamed for this situation, since it is merely creating a supply of securities the demand for which it has only an unimportant part in creating. It is probable that if the supply of investment-company securities were not increased at such a time, the entire demand would take effect in the form of the purchase of the securities of investment companies that were in existence, which would result in a much greater increase in the prices of these securities. Management investment companies cannot be blamed for the time at which they are organized, but they can be blamed for not adjusting for a probable future decline in security prices. The difficulty in this connection is that the companies begin operations before their managements have accumulated experience and just at the time when proper adjustment of portfolios is most difficult.

In any event it is improbable that at any time in the future management investment companies will as a group make such serious mistakes as they did in 1928 and 1929, largely because the top of the next speculative boom will probably find some other financial institution in the favor of the public and there will not be so many new and inexperienced management investment companies formed.

Another difficulty involved in the rapid growth of the management investment company concerned the quantity of skilled investment management available. The ability to analyze investments and manage investment funds cannot be acquired quickly. The total quantity of such ability could not increase as fast in 1928 and 1929 as the demand for it nor as fast as the new "investing public" believed that it had increased. This meant, of course, that many of the newer companies could secure only incompetent and inexperienced management.

It is probable that investment-company organizers were deceived by the "new era" philosophy as to the probable course of future events as much as those to whom they sold investment-company securities. Organizers were interested in the profits of promotion, but they expected to secure these profits in the form of large dividends and increases in the market prices of "management shares" or blocks of common stocks which they took as a reward for the promotional

function. If they had not expected the market to continue its rise they would have taken their profits in some other fashion. This is not to deny, however, that many promoters, after the companies had been organized, saw that the rise could not continue forever and sold their shares in the market before the break. This was particularly true of the professional promoters who knew nothing about investment management and knew that they knew nothing about it.

Students of the contractual type company are generally agreed that this type, particularly in so far as it has been used in connection with a fixed portfolio, is distinctly an American development. This point of view is not only presented in the American literature, but is admitted in the British and Continental literature on the subject. For example, the *Manchester Guardian Commercial* for January 27, 1934 (p. 63), begins an article on the fixed company as follows: "Since the first immigrant fixed trust arrived in this country per the United States nearly three years ago. . . ." Similarly, an article in the *Spectator* for June 7, 1935 (p. 994), contained the statement that "Though viewed with a certain amount of misgiving when it first appeared on this side of the Atlantic from the United States, the 'fixed trust' principle has evidently met a popular need. . . ."

The principles involved in the organization of the contractual type company are much older, however, than the adaptation of the principles to the investment company, and many of these principles have come from European practice. In so far as this type of company makes use of the trustee relationship, as most of them do, the investment company is merely one of many uses to which the trustee device has been put.

The principles underlying the contractual investment company seem to have been applied in France about 1850. A number of trusts were formed at that time based upon representative European stocks. The companies involved the deposit of common stocks with a trustee and the issuance of shares representing beneficial interests in the deposited property. Periodic distributions were made on the shares. The idea never developed to a great extent, however, either in France or in England, where attempts were made to popularize it, partially because of the small number of corporations in both countries the stocks of which were available in the open market.

The principle of depositing a group of securities and issuing par-

ticipating certificates on the basis of these securities has been used in a number of other connections. For example, the device has been employed on many occasions to permit the purchase of high-priced securities by investors of limited means. Stocks selling at high prices have been deposited with trust companies and the proprietary interest split up through the issuance of participating certificates in convenient smaller denominations. The effect of such a procedure is somewhat similar to an ordinary stock split-up in which the outstanding stock of a corporation is divided on the basis of two, three, or four shares of new stock for each old share held. The net effect is to bring about a broader distribution of high-priced stocks.

The Stock Conversion and Investment Trust of London was organized in 1889, primarily for the purpose of acquiring railroad securities, depositing them with itself as trustee, and issuing several series of securities against them. In a number of cases this company has acquired railroad stocks and issued first and second preferred and common stocks against the deposited stocks. This practice has also been followed by the London, Midland and Scottish Trust, which was organized in 1924 by people associated with the Stock Conversion and Investment Trust. It was essentially a device for splitting up the underlying shares into different preferences. While the idea of the deposit of securities and issuance of shares on the basis of these has been taken over by the contractual type investment company, no important attempts have been made to split the deposited securities on the basis of different preferences.

One of the best examples of the early use of the depositary device for the splitting up of shares was the Investors Share and Unit Corporation of New York. The corporation bought stock of the Ford Motor Company of Canada, Ltd., and deposited the stock with the American Trust Company, New York, as trustee. The trust company received the stock and issued "bankers shares" representing 1/100th share of the Ford Motor Company of Canada stock. Owners were entitled to all dividends and had the privilege of converting an aggregate of one hundred "bankers shares" into one share of Ford Motor Company of Canada stock. The Ford Motor Company objected to the use of its name in this connection and the issue encountered strong disfavor, partially also because of the wide "spread" (commission exacted by the organizers).

Another example of this situation is the issuance of bankers shares by Henry L. Doherty. Mr. Doherty in 1919 decided that a broad public participation in the stock of Cities Service Company was desirable. To effect this he made an arrangement with the management of a bank by which it would act as custodian for shares of stock of his company and issue in return for each share received ten "bankers receipts," which were sold to the public. Mr. Doherty because of this action has sometimes improperly been called the one who established the fixed company.³

The practice of issuing mortgage bonds in convenient denominations on the basis of a single large mortgage on a piece of real estate is another example of the principle by which the total mortgage is split up in order to make it more marketable.

The principles involved in the deposit of securities and the issuance of participating shares have also been used in connection with the sale in the United States of foreign securities. In a number of cases securities issued by European firms have been deposited with American banks as depositaries and "American depositary receipts" issued and sold to American investors. This process has been carried on in connection with shares of the Discount Company of Amsterdam, the Copenhagen Handelsbank, Courtold's, the Dresdner Bank in Berlin, and many others. A similar use of the principle has been made in the issuance of certificates by financial trust companies in Holland, particularly the Administratie Kantoor, against the deposit of American securities. This practice arose as a result of the requirement of the Amsterdam Stock Exchange that securities traded thereon must be in bearer form. A procedure closely approaching the fixed investment company is found in a few cases in Holland where groups of foreign stocks, generally restricted to one field, have been deposited and certificates issued against them. The motive for this, however, is the facilitating of trading rather than the provision for diversification of risk.

Corporate reorganizations and a change in the legal form of a business organization, as well as the familiar voting-trust principle, have often involved the deposit by security-holders of their shares with a bank or trust company and the distribution to them of receipts issued against their deposit.

³ See *Keane's Investment Trust Monthly*, December, 1931, p. 572.

While many of the principles used in the contractual type investment company are evidenced by conditions found in the foregoing examples, in every case the procedure followed has some other motive than that which is of greatest importance in the formation of the contractual type investment company, namely, the provision of investment diversification. When the factor of diversification is taken as the criterion of the contractual type investment company, the origin is fairly recent.

Probably the first true fixed company of the contractual type was organized in 1923 with the issue of United Bankers Oil Shares, representing ownership in ten Standard Oil stocks. The story is told that when this first occurred, every newspaper in New York City sent a reporter to interview the individual who they had assumed was attempting a merger of the same oil interests that the United States Supreme Court had split up in 1911.⁴

The contractual type company, "bankers share" company, or "stock conversion" type company began to assume importance in the United States as an American variant of the investment company about the same time as the true British type. Six companies of the contractual type were organized in 1924.⁵ The disastrous failures of some of the early American companies patterned along British lines early led to the advocacy of an American type which should involve a fixed portfolio with little managerial discretion. It was quite generally considered in 1924 and 1925 that the "American type" would prove to be more important in the United States than the management type, particularly in view of the lack of state and federal regulation in the United States.

The growth of the fixed type company, however, was slow up to late 1929, while after 1926 the numbers and resources of the incorporated management type increased rapidly. The investing public believed in management. This type had the experience of the British companies to use as examples, at least in advertising their wares to the public. Since the leverage feature was not found in contractual-company securities the prices of their shares could rise only as fast as the value of

⁴ *Ibid.*, March, 1931, p. 183.

⁵ See R. A. Lewis, "The Bankers Share Companies," *Journal of the American Bankers Association*, February, 1925, pp. 491-92, 526-27.

the underlying property, and this was not fast enough for the 1927-29 speculator. The redemption feature made it impossible for shares of contractual companies to sell at premiums above liquidating values, and this put another brake on the ability of shares to rise in price with which management type companies did not have to contend. We have already seen that during the first three quarters of 1929 over two billion dollars worth of securities of what were known as investment companies of the management type were disposed of, but that much of this involved new capital issues by holding companies, finance companies, and trading companies.

With the break in common-stock prices in September and October, 1929, the reversal of trend was immediate. The common stocks of management companies fell precipitately, but the participating shares of fixed companies held up well. Promoters who had been planning the organization of new management companies "postponed" their formation, but in succeeding months a horde of new fixed and semifixed companies appeared on the scene. During the break the average decline of the common stocks of sixty-two companies of the management type was 69.08 per cent, while the stock market as a whole declined 50 per cent. Shares of fixed companies declined least of all. North American Trust Shares (Original Series) was able to report that during the week of the worst break in the market in October, 1929, the company had the largest volume of sales of any week of the year 1929 up to that time.

The principal reasons why the fixed company was able to weather the storm of September and October, 1929, were that the shares were not selling at premiums above liquidating values when the break came, the ability of shareholders to convert their shares at liquidating values, the fact that the "blue chips" were held in portfolios rather than the more highly speculative issues in newer industries, the interest of the sponsors in maintaining markets for their shares, the fact that billions of dollars worth of new management-company securities were largely in the hands of speculators and were thus undigested, and the fact that the fixed company involved no management feature at a time when the investing public was turning "sour" on management. The belief during 1930 and early 1931 that the stock-market decline was over encouraged the purchase of fixed-company shares by small investors who were eager

to recoup their losses and whose funds were insufficient to purchase sizable amounts of the underlying stocks directly. As an article in the *Commercial and Financial Chronicle* for May 3, 1930 (p. 3098), states: "The decline in stock prices has attracted purchases of these shares by small buyers who have long been waiting for just such a break in the market as has occurred." The year 1930 was a "fixed-trust year" as 1929 had been a "management-trust year."

A report of the attorney-general of the state of New York in the middle of 1930 indicated that replies to questionnaires by forty companies of the fixed type showed \$254,844,049 in participating certificates of fixed and semifixed companies outstanding on March 31, 1930.⁶ A writer in the *New York Journal of Commerce* for April 25, 1930, estimated that \$200,000,000 worth of certificates were at that time outstanding as compared with \$50,000,000 a year earlier. John F. Fowler, in an article in *Barron's* on June 9, 1930 (p. 5), estimated that over one hundred companies of the fixed and semifixed type had been formed which had sold about \$300,000,000 worth of participating shares and that fifteen hundred security dealers were engaged in selling shares of such companies. In the January, 1931, issue of *Keane's Investment Trust Monthly*, Clarence Starr estimated that \$500,000,000 in participating shares had been distributed up to that time. John W. Newey in February, 1931,⁷ stated that the volume of participating shares of fixed and semifixed companies outstanding had increased during 1930 from \$150,000,000 to \$400,000,000. At the top of the fixed-trust boom in April, 1931, fixed-company shares were held by about 250,000 "investors." The list of "unobjectionable" companies published by the New York Stock Exchange in September, 1931, indicated that about 70,000,000 fixed-company shares were outstanding and that about 5,500,000 shares of stock had been deposited in fixed and semifixed company portfolios.⁸ Estimates of the value of participating shares outstanding at the peak range up to \$1,000,000,000, but it is probable that a figure of \$750,000,000 represents a reasonable maximum estimate.

We have already seen that in 1931 the fixed company fell into

⁶ See *Keane's Investment Trust Monthly*, July, 1930, p. 504.

⁷ See "The Outlook for the Fixed Trust," *ibid.*, February, 1931, pp. 67-68.

⁸ See *ibid.*, November, 1931, p. 519.

disrepute and was succeeded by the semifixed company. When sponsors adopted discretionary portfolio elimination provisions they in effect admitted not only that a fixed portfolio could not be justified but that circumstances could not be fixed in advance upon the occurrence of which eliminations from portfolio should take place. These changes involved an according to management functions of an increased importance in the contractual company setup. After 1932 many companies attempted to avoid the use of the word "fixed" altogether. The term was, of course, a misnomer from the start, since practically all companies included provisions for portfolio eliminations under certain conditions. The term became popular largely because of its sales value during the period of the reaction from management. When the antagonism toward management began to wane the term "fixed" came into some disrepute and this led to efforts to find a substitute term. Many companies adopted the term "unit type trust" or "unit share trust." This term referred to a company not on the basis of the degree of management involved but rather on the basis of the division of the portfolio into units. The "unit type" term as used subsequently to 1932 is synonymous with the unit series group of the contractual company.

The unit type company declined for several reasons, the most important of which were the continued decline in stock prices to 1932, irresponsible sponsorship, a gradual increase in confidence in the management type, ill-advised efforts to stimulate sales of shares by questionable merchandising methods, the inauguration of new series and the "switching" evil, portfolio eliminations and returns of capital to the investor, the decrease in distributable income and the disappearance of reserve funds, the publication of the requirements of the New York Stock Exchange, restrictive state regulation, and certain internal dissensions in the fixed-company field. This latter item relates to intense disagreement among sponsoring groups on certain fundamentals, such as to the policy of capital accumulation versus maximum distribution, the use of the reserve fund, the degree of management and supervision, and the use of the periodic fee. The investing public lost interest in an institution on the principles of which the sponsors themselves could not agree.

CHAPTER III

THEORY OF THE CONTRACTUAL TYPE INVESTMENT COMPANY

The theory of the contractual investment company can best be described and explained by contrasting the principal features of this type of company with the incorporated or direct investment company. In a few cases some overlapping in characteristics is found—that is, a characteristic which is general for the incorporated company may be found also in a few contractual companies and vice versa—but in general the principles on which the contractual or indenture type company is organized and operates are antithetical to those of the direct type company. The analysis in this section will be made largely, therefore, in terms of these contrasts. It is assumed at the start that the reader is familiar with the principles found in the organization and operation of the incorporated or direct type company, since these matters have been adequately treated in the literature.

In considering the contractual investment company it is well to remember that no new securities are issued by this type of company. The participating shares which are issued are merely receipts for securities which have been deposited with a trust company or other agency. The deposited securities are thus taken out of the investment market and remain out of the market so long as the participating shares are in existence. No new financing of industrial undertakings is represented by the issuance of participating shares of contractual investment companies.

One of the chief differences between the statutory and contractual type company is that the former may and often does issue several types of securities, whereas the latter almost always issues securities of only one class. The incorporated investment company commonly issues different classes of common stocks, including issues with different forms of preferences, and also bonds, usually of the debenture class. This type of company “trades on the equity” for the common stockholders. The term “leverage” as applied to the common stock of the

investment company has achieved considerable popularity in this connection. Since the shares issued by the contractual investment company represent a proportionate claim on the earnings of specific deposited trusted property the issuance of prior claims is impossible or inconvenient.

In the purchase of the securities of an incorporated investment company, therefore, the investor can often take his choice between a bond having a fairly certain income at a low rate, a preference stock offering a contingent income at a somewhat higher rate, and a common stock offering a residual claim on earnings. The investor in a contractual investment company can buy only shares of one class. Earnings on the shares vary in direct proportion to the variations in earnings on the property placed with the custodian for which the shares are receipts. The investor is thus in approximately the same position, so far as a claim on income and assets is concerned, as the purchaser of shares in an incorporated investment company issuing only one class of stock and no bonds.

The principle of "leverage" is generally familiar to the student of the investment company, but it will be well to summarize the principal features at this point. Chase Donaldson has presented in the December, 1934, issue of the *Review of Reviews* an interesting analysis of a hypothetical company to show the effect of the leverage factor. He uses Table 4 to indicate the differences resulting from changes in asset values in the case of a leverage company, a nonleverage company, and a mutual fund company.

In each case it is assumed that the company is formed at the beginning of 1929 with total net assets of \$10,000,000. Against these assets the leverage company issues \$2,500,000 principal amount of bonds, \$2,500,000 par amount of preferred stock, and 1,000,000 shares of common stock. At the time of formation of the company, the bonds and preferred stock were backed by a coverage of four to one and three to one respectively. The common stock had an asset value of \$5.00 per share, but Donaldson explains that it may be assumed that at the time the stock was selling in the open market at \$7.50 per share, a 50 per cent premium.

The post-depression situation assumes a decline in security values of 47 per cent. Protection behind the company's bonds and preferred

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stocks has declined substantially as indicated. The asset or liquidation value of the company's common stock, however, has declined about 94 per cent. If the company's total assets were to appreciate to their

TABLE 4*
TYPES OF INVESTMENT COMPANIES

	Leverage Company	Nonleverage Company	Mutual Fund
Original (predepression):			
Total net assets.....	\$10,000,000	\$10,000,000	\$10,000,000
Bonds (face value).....	2,500,000		
Assets per \$1 of bonds.....	4		
Balance.....	\$ 7,500,000	\$10,000,000	\$10,000,000
Preferred stock (par value).....	2,500,000		
Assets per \$1 of preferred.....	3		
Balance.....	\$ 5,000,000	\$10,000,000	\$10,000,000
Common stock—number of shares.....	1,000,000	2,000,000	2,000,000
Asset value per share.....	\$ 5.00	\$5.00	\$5.00
Net assets working per share.....	\$10.00	\$5.00	\$5.00
Market price per share.....	\$ 7.50	\$6.00	\$5.00
Leverage†.....	1½ to 1	None	None
Present (post-depression):			
Total net assets.....	\$ 5,300,000	\$ 5,300,000	\$ 5,300,000
Bonds (face value).....	2,500,000		
Assets per \$1 of bonds.....	\$2.12		
Balance.....	\$ 2,800,000	\$ 5,300,000	\$ 5,300,000
Preferred stock (par value).....	2,500,000		
Assets per \$1 of preferred.....	\$1.12		
Balance.....	\$ 300,000	\$ 5,300,000	\$ 5,300,000
Common stock shares.....	1,000,000	2,000,000	2,000,000
Asset value per share.....	\$0.30	\$2.65	\$2.65
Net assets working per share.....	\$5.30	\$2.65	\$2.65
Per cent appreciation in asset value of common stock in event of return to predepression status.....	1,567%	88.6%	88.6%
Market price per share.....	\$2.00	\$2.25	\$2.65
Leverage†.....	2.65 to 1	1.18 to 1	None
Per cent appreciation in market price of common stock in event of return to predepression status.....	275%	166.5%	88.6%

* Hypothetical cases to illustrate the features of the three different types of investment companies and their securities—before the depression and after.

† Computed on the basis of the relationship of the market value of the stock (since this represents the price which must be paid to acquire the stock) to the assets working for the stock.

initial value, all such appreciation would apply to the common stock. The bonds and preferred stock provide "leverage" to the common stock, making the common-stock asset value fluctuate much more violently up and down, percentage-wise, than the company's total assets.

The use of the "trading on the equity" principle in investment-company finance has given rise to one of the principal arguments between the proponents of the incorporated type and of the contractual type. Those who contend for the use of the device point to the experience of investment companies in Great Britain, which, during the period of rapid organization in the late 1880's and the decade of the 1890's, made use of the principle. A large proportion of the British and Scottish companies in existence today show both debentures and shares outstanding.¹ The net effect has been an increase in income to the shareholders of British companies as compared with that which would have accrued to them if there had been no "trading on the equity." Those who are in favor of the issuance of one class of shares only contend that while "trading on the equity" has probably benefited the stockholders of British companies, the conditions existent at the time many of the companies were formed were far different from those found during the decade of the 1920's and that these differences are important enough to warrant a difference in conclusion as to the advisability of the use of the principle. In the late 1880's and in the 1890's interest rates were low. Obligations could be issued at rates of interest as low as 4 per cent, and since the yield on shares was somewhat higher than this the funds received from the bondholders could be used to purchase shares for the portfolio, a part of the income of which would accrue to the stockholders of the investment company. Borrowing by the British companies usually matched the capital paid in on the stock certificates. Thus, if for every £1,000 of debentures at 4 per cent there were issued £500 of preferred at $4\frac{1}{2}$ per cent and £500 in ordinary stock, only $3\frac{1}{3}$ per cent would have to be earned on the total investments in order to meet the fixed obligations. This requirement was typically

¹ See George Glasgow, *The English Investment Trust Companies* (New York: John Wiley & Sons, 1930); and G. Glasgow, *The Scottish Investment Trust Companies* (London: Spottiswoode & Co., 1932).

met by means of a backlog of seasoned bonds, which usually included sound foreign issues.

In the decade of the 1920's, on the other hand, conditions were far different. Interest rates were high as compared with stock yields. Obligations and preference stocks could be issued and sold only at rates which would give to their holders most of the earnings from the property purchased with the proceeds from their sale. This same situation faced companies organized in Great Britain in 1888 and 1889. Debentures at 4 per cent became more difficult to float and choice investments at 7 per cent to 9 per cent became correspondingly scarcer. Because of this situation the newer companies had to resort to the purchase either of desirable securities at peak prices or of speculative issues. This is one of the causes of the difficulties in which the British investment companies found themselves in the crisis of 1890. The experience of the British companies was not heeded by the American investment company sponsors, however. Taking the period between the beginning of 1928 and May 1, 1930, we find that three bond issues were put out by American investment companies at a $4\frac{1}{2}$ per cent rate, fifty at a 5 per cent rate, eleven at a $5\frac{1}{2}$ per cent rate, and fourteen at a rate of 6 per cent. Preferred shares were issued at rates from $5\frac{1}{2}$ per cent to 7 per cent and even as high as 8 per cent. Many of the bonds were convertible and many of the preferred-stock issues were participating or convertible, so that, even in a period of rapidly advancing security prices, much of the benefit accrued to the senior security-holders rather than the common stockholders. Considerable senior security financing by incorporated investment companies actually took place in the 1920's in such a way that the rate to be paid on the securities issued exceeded the yields current on the securities which were to be purchased with the proceeds, since the average yield on common stocks during the decade of the 1920's was about 4 per cent. Thus the owner of senior securities had not only a lien on all the current earnings of the property in the portfolio but also a lien on anticipated increased earnings or on profits from trading activities of the company.

A survey made in March, 1929, of 160 investment companies of the management type with an aggregate capital of \$1,034,000,000 indicated that 20 per cent of the combined capitalizations was in debentures,

42 per cent in preferred stocks, 33 per cent in common stocks, and 5 per cent in beneficiary certificates. This survey reflected the situation existing before 1929 when bonds and preferred stocks were still salable. During 1929 the bonds and preferred stocks of most investment companies sold at "discounts" because of the demand for common stocks. This was particularly true of debentures and preferreds not possessing the convertible feature.² During 1929 also a number of companies abandoned the British investment traditions entirely and sought their income primarily from stock trading and underwriting. One of the largest companies obtained its 1929 income of \$25,646,074 as follows: \$2,787,116 from interest, \$3,696,575 from dividends, and \$19,162,383 from profits on sales and participations.

Proponents of the contractual investment company also have pointed out that the favorable record of the British companies which used the "trading on the equity" principle resulted from conditions existing during a period of generally rising prices which would tend to maximize the benefit to the shareholder from the use of the device. It was contended that there was no certainty that the years following 1920 would be marked by such a rise in the price level as took place from 1890 to 1920; in fact the indications were to the contrary.

The history of the price level and of interest rates to date has shown that those who favored the issuance of only one class of shares during the decade of the 1920's were correct. However, because of the long rise in stock-market prices during the decade, the tendency of common stocks of incorporated investment companies which had senior securities outstanding to sell at premiums above asset values and other "new era" phenomena, this group was "as a voice crying in the wilderness." That group of incorporated investment companies whose capital structure was so arranged as to involve "trading on the equity" to the greatest extent suffered more severely in the period from 1929 to 1932 than any other group. The prices of the common stocks of this group represented up to 50 per cent premiums above asset values when the crash came and thus the decline affected the common stocks of these companies more disastrously than those of companies in other groups. It is interesting to note in this connection that in England, in spite of the splendid record of the British com-

² See *Commercial and Financial Chronicle*, December 7, 1929, p. 3529.

panies, the prices of investment-company shares have consistently remained at or near the asset value, seldom showing a variation of more than 10 per cent from such value.³ Companies having bonds and preferred stocks outstanding, and thus having fixed and contingent charges to meet, felt it necessary to invest larger amounts in speculative issues with the hope of counteracting low-income yields by trading profits and thus securing income sufficient to meet their charges. This is another result of the sale of senior securities at high rates of interest. The British companies have followed the opposite practice of balancing their own outstanding senior securities with similar securities in the portfolios, thus assuring them of sufficient income to pay fixed charges regardless of the course of the stock market.

The American practice resulted in a situation in which companies which "traded on the equity" found themselves holding large proportions of highly speculative securities at the time of the market crash in 1929. Thus the decline in prices affected the portfolios of this group of companies more severely than those of companies which had lower fixed charges to meet and did not need to take such great chances. In addition, because of the prior claims on assets, the asset value of the common stocks of this group of companies decreased much faster than the values of stocks of companies having no senior securities. The "flight from management" also hit this group the hardest and resulted in the greatest discounts from break-up values, at least for a time.

The common stocks of companies issuing only one class of security do not suffer from the "trading on the equity" factor in declining markets. This was the case with many incorporated and unincorporated management companies and in almost all contractual companies. In those few contractual investment companies which had class "A" and "B" shares outstanding, the "B" shares were "management shares" and were not held by the public. Early in the market decline their asset value disappeared, but since they were not in the hands of the public this fact did not affect detrimentally the prestige of these companies. As a whole, however, it may be said that the incorporated management type company represented the utilization of the "trading on the equity" principle, whereas the contractual type is repre-

³ See E. L. Smith, "The Bank and the Investment Trust," *Keane's Investment Trust Monthly*, March, 1930, pp. 229-31.

sentative of the "one class of shares" principle. Thus a prolonged market decline was sure to affect favorably the contractual type company relative to the direct type so far as this factor was of influence. It is for this reason that proponents of the contractual type company contend that there may be a place in the financial system for both the incorporated investment company and the contractual company but that it should be recognized that the common stock of the former is speculative, whereas the shares of the latter should be classed as an investment.

The holder of shares of an investment company issuing one class of shares only is not foregoing all the advantages (and disadvantages) of the leverage feature. The common stocks of companies found most often in the portfolios of fixed and semifixed investment companies themselves represent the use of the "trading on the equity" principle as a result of bonds and preferred shares outstanding. Many constituent companies in investment company portfolios are holding companies. These companies "trade on the equity" for their common shares, and in addition the total assets of the companies are common stocks of operating companies which also have bonds and preferred stock issues ahead of the common. This introduces double leverage into the ownership of holding-company stocks. The extension of the leverage feature to the capital structure of the investment company would appear to be unnecessary to give the investor in investment-company shares sufficiently wide variations in the value of his investment. When we find a management investment company with leverage holding in its portfolio the shares of other investment companies having the leverage feature which in turn hold in their portfolios shares of holding companies with bonds and preferred issues outstanding, the assets of which consist of stocks of operating companies with "wet" capitalizations, leverage would appear to be carried to the point of absurdity.

It is not desired to give the impression that all incorporated companies have followed the policy of "trading on the equity" in the arrangement of their capital structure. Particularly toward the end of the bull market in 1929 the nonleverage company assumed increasing importance. The practice of trading on the equity has not been followed so extensively as in the case of the British companies, and, where it has been followed, the proportions of senior securities to junior

equities has often been smaller. This has not been due to the conviction on the part of incorporated investment company managers during the period of rapid development of this type in the late 1920's that "trading on the equity" was not desirable, but rather to the fact that during the great speculative boom in 1928 and 1929, when incorporated management companies were being formed most rapidly, bonds and preferred stocks could not be sold easily, whereas "investors" were quick to snatch anything that looked like a common stock. This resulted in many of the incorporated companies organized during the latter part of the boom having a larger proportion of common stocks in their total capitalization than would otherwise have been the case, a fortuitous circumstance for which investment-company managers have since been duly thankful. Not only do many incorporated companies have common shares only outstanding, but this practice is quite common with companies organized as Massachusetts or common-law trusts. The situation is also found in the case of mutual fund companies—that is, management companies of the statutory or contractual type which provide for continuous redemption of their shares. There has been a tendency in recent years for statutory type companies issuing only one class of shares to become mutual fund companies. Prestige has accrued to the mutual fund type of company during the depression because of the fact that, since the sponsor of the company agrees to buy back the stock at any time at a price based on its asset value, sale of the stock at a discount is impossible.

The first reaction against management caused the common stocks of all investment companies not possessing the mutual feature, whether or not they were of the leverage type, to sell at a discount from break-up values. As the decline in stock prices continued, however, a divergence occurred between the common stocks of companies involving leverage and those of companies which issued common stock only. The former soon rose to their liquidation values and began to sell at premiums, whereas the latter have continued to the present time to sell at discounts. The net assets attributable to the common stock of companies possessing the leverage feature declined faster than the market prices of the leverage stocks, thus changing the sale at a discount into sale at a premium. Two important factors account for the change. In the first place, publicity with regard to the leverage feature

and the benefits which would accrue from holding common stocks which had this feature gradually caused investors to accumulate stocks of this kind, which increased the demand and narrowed the discount. This tendency became particularly prominent when the belief in the imminence of inflation became a factor in the markets. Second, the net assets attributable to the common stock declined to such an extent that in many cases there were no assets left for the common. The common stocks were then "under water," yet speculators were willing to pay something for the stocks as a "call" on future advances in market prices. For several years stocks of this class sold at prices from \$1.00 to \$5.00 per share, sometimes called the "cushion levels." During the past two years, however, discounts have again appeared in many of the leverage stocks as the result of a rise in asset values greater than the market values of such stocks.

Another fundamental difference between the incorporated type company and the contractual type is with regard to redemption and conversion of shares. Shares of contractual type investment companies may be continuously or at frequent periodic intervals redeemed or converted and thus the shares cannot sell much above or much below break-up or liquidating values. Shares of incorporated investment companies which do not possess the mutual feature, on the other hand, are not subject to conversion or redemption and sell at prices determined by the demand for and supply of the shares in the open market. Since new shares can easily be created by contractual companies and since redemption is relatively simple, the bid price of the contractual investment company's shares in the open market cannot long remain above the company's offering price, nor can asked prices of the shares in the open market long remain below the liquidating value. Thus, during the long market decline from 1929 to 1932, the prices of contractual investment company shares decreased approximately only as fast as the market prices of the underlying securities. These declines were, the reader is well aware, tremendous, since most contractual type companies held only common stocks in their portfolios, but the declines were not so great as the prices of shares of companies which had issued senior securities.

Another factor in the popularity of the contractual type company, partially a cause of the popularity and partially a result, was the fact

that during the period of greatest prominence of the fixed company in 1930, some of them were selling at premiums relative to their liquidating values and a few of them were even selling at premiums higher than the difference between the liquidating value and the "spread," indicative of a situation in which participating shares were apparently not being created fast enough to satisfy the demand! A study of this factor was made by the School of Commerce, Accounts, and Finance of the University of Denver in 1930 which showed that in May of that year, the market prices of North American Trust Shares (1953) and Corporate Trust Shares (Original Series) were 124 per cent of their liquidating value.⁴ Other figures were: Fixed Trust Shares, 103 per cent; Basic Industry Shares, 111 per cent; Diversified Trustee Shares, 101 per cent; Diversified Trustee Shares, Series "B," 103 per cent, and Investor's Trustee Shares, Series "A," 110 per cent. The composite index of relatives was 111 per cent for the month of May, 1930. Thus market prices of the fixed-company shares included in the analysis exceeded their liquidating values by 11 per cent, which is slightly more than the average "spread." However, in some cases the prices of the underlying securities used in the computation of the offering price were higher than those used in the computation of the liquidating value, and so it may be said that the premium above liquidating value represented a willingness of buyers to pay in the open market for the shares as much as was being asked by the sponsors.

The composite indexes for the months during the stock-market crash in late 1929 are interesting. The index number for September was 104 per cent; for October, 113 per cent; for November, 114 per cent; and for December, 102 per cent. This shows that the prices of fixed-company shares declined no more than the prices of the underlying securities during the crash and during the months when stock prices were declining most rapidly, the prices of the fixed-company shares appear to have lagged behind the declines in the prices of the underlying securities. This is strong evidence of the interrelations existing between the decline in prices of common stocks, the reaction against management, and the resultant increase in the popularity of the fixed company. The fact that the fixed companies which are under consideration held common stocks only in their portfolios while this was

⁴ *American Experience with Investment Trusts* (1930), p. 6.

not the case with many management companies renders the record all the more astonishing and would seem to indicate that, so far as the investment-company movement is concerned, the decline in 1929 indicated a "flight from management" rather than a reaction from the common-stock theory of investment.

The fixed companies were quick to capitalize these facts. There were not many fixed companies in existence at the time of the crash, but those which were operative advertised the results of the decline on the prices of their shares. North American Trust Shares, for example, was able to advertise in December, 1929,⁵ that the prices of their shares declined only three points from the all-time high to the low of October 29, 1929, or 24 per cent, and that the price had subsequently recovered to levels above the original offering price in early 1929, while fifty-three "management trusts, trading corporations and investment companies, listed on the New York Stock Exchange and New York Curb Exchange declined *on the average* 67 per cent from the year's high to the low of October 29." Fixed-company sponsors pointed out as an evidence of the inefficiency of management the fact that, although theoretically the management type possessed the ability to trade in and out of the market in anticipation of market declines, it did not do so, and that the fixed type which lacked flexibility weathered the break most satisfactorily.

No more vital difference occurs between the direct or statutory type company and the contractual type than with regard to investment policy, particularly as that policy relates to the question of the degree of management. A few cases of incorporated companies having a more or less fixed portfolio are found and there is a considerable number of contractual type companies, particularly of the fund group which are of the management type, but the great majority of incorporated companies are of the management type and a large proportion of contractual companies follow a policy of fixity or semifixity in the portfolio. The positions of the two contending groups are not difficult to state, but they are much more difficult to evaluate. The management company contends that the dynamic nature of economic society makes it impossible to select a group of securities and maintain this original list over a period of years without re-examination and without change.

⁵ See *Keane's Investment Trust Monthly*, December, 1929, inside front cover.

Changes in financial and in economic conditions, in outlook and position of different industries, and in the status of individual issuers, it is held, result inevitably in impairing the investment value of some securities and enhancing that of others. No industry is so sound, no company so conservatively progressive, and no stock or bond so inherently good that time may not completely alter its investment standing.

It is also impossible, the contention runs, to state in advance under what conditions a security ceases to be in the investment class and justifies elimination from a portfolio. They thus condemn the non-discretionary elimination provisions found in the true fixed company. The proponents of the management type contrast the list of recognized "blue chips" of ten, twenty, and thirty years ago with the list today and place emphasis upon companies in the lists of former times which are today nonexistent or are not in the "blue-chip" class.

The upholders of the fixed portfolio have countered with a number of arguments. The fixed portfolio eliminates the "human equation" and thus avoids the results of inefficient or corrupt management. Thus, even though the investment status of some companies originally selected may change, the situation may be better than would have been the case if management of the portfolio were permitted. Most fixed-company proponents will admit that it is at least theoretically possible for a skilled and competent management to show a better record over a period of years than will a fixed portfolio, particularly when the investment policy is such that the management can shift from bonds into stocks and vice versa with changes in the business cycle. However, fixed-company sponsors question the ability of management to show a better record as a practical matter and point to the mistakes made by managements in 1928 and 1929. It is claimed that although certain industries may become obsolete and certain corporations may fail, the leaders generally show a power of adaptability to changing requirements and methods and maintain their relative positions. Management is not eliminated—it is merely shifted to the companies whose securities are purchased. It is suggested that even though some of the companies originally selected may fail entirely, yet in a country which is expanding economically, the gains from the companies which are successful will more than offset the

losses. Thus reliance is placed upon diversification and the principle of averages. Some companies may fail, but that is the reason for selecting a considerable number of companies in the first place, to secure the advantage of the law of averages.

When it is pointed out that many "blue chips" of past periods are out of existence today, the fixed-company sponsor admits that in the past, during a period of rapid economic change and development, the fixed portfolio was economically unjustifiable, but claims that now conditions are different. The sponsor contends, or contended in 1930 at least, that business had achieved a greater degree of stability and that the future was less likely to show violent changes in the relative positions of industries and of companies within industries. Such reasoning, of course, was based upon figures taken from the 1920 to 1930 period, which naturally have not been substantiated by subsequent events. Taking a long-time point of view, it is difficult to see that greater business stability is being achieved and it is not easy to see what factors are at work which are likely to bring this about in the future. The only stabilizing factor which may be prognosticated with any degree of certainty is the slowing down in the rate of increase of the population, and what effect this will have as a stabilizing force is unknown. On the other hand it must be admitted that the depression has had remarkably little effect upon the constituency of the list of "blue chips."

It is natural that the sponsors of fixed companies should have done their best to justify their existence and growth during the 1930-31 period. However, they became popular not because analysts were able to justify them economically—but, rather, attempts were made to justify them because they were popular. The American public seems to like to go to extremes and the extreme of the fixed portfolio was a natural aftermath of the "management" boom. In 1928 and 1929 the investing public virtually begged any one who set himself up as an "investment-trust manager" to take their money; in 1930 and 1931 the investor would not touch anything which savored of the least discretion. Both, of course, are unfortunate extremes.

In late 1931 and later the fixed-portfolio idea declined and now the true fixed company is practically dead. Again this was a result not of conclusions drawn from economic analysis but was due simply to the

fact that fixed-company shares would no longer sell, whether or not the public *should* buy them, and consequently there was no need for proving the economic justification of this type of company. The fixed company, as we have seen, was succeeded by the semifixed company, which involved eliminations from the portfolio as determined by one or more investment-counseling firms. Continuous supervision is involved. This represents a much greater retreat from the policy of fixity than is generally supposed, even though the result may be a more fixed portfolio than under the truly fixed type. The portfolio is continuously supervised, which is all that is done in the case of the management type. Changes take place in the portfolio of the semifixed type only for long-time investment reasons, which is the only reason changes are supposed to take place in the management type. More changes are likely to take place in the management type than in the semifixed portfolio, but all changes and the results of the changes are dependent upon the capability of the management. Thus, even though changes take place less frequently in the semifixed type, management actually assumes an important place in portfolio administration. The term "semifixed" probably was adopted only because when the type became popular the sponsors wanted to find some name that would not involve the use of the word "management." Similar companies in England of more recent origin where the term "management" has not been in such disrepute frankly call the sponsors of the company the "managers."

The function of supervision as exercised by the investment counselors in the semifixed company would be much more efficient were it not for the popular prohibition of substitutions. This again results from the attitude of the investing public, which at the time discretionary elimination provisions were introduced was unwilling to go so far as to give the management permission to add securities not originally in the portfolio. This provision against substitution is probably the greatest weakness in the entire semifixed-company setup.

Another significant difference between the statutory company and the contractual company is in connection with the contents of the portfolio. The differences between these two types of companies in the United States, however, are less significant than the differences between

both types and the British management type company. Partially as a result of the lesson learned by the British companies during the period from 1890 to 1895, most of them diversify carefully as between obligations and equities, with a tendency to invest far larger proportions of their funds in obligations than is the case with American companies. Statistics reveal only a slight weakening in this tendency among British companies even during the postwar inflation of stock prices to 1929. As a result the British management companies were in a good position to meet the decline in stock-market values which began in 1929 and have shown far better records during the depression than their American counterparts, with consequently less disastrous effects upon the prestige of the British management companies.

American management companies have consistently placed much larger proportions of their assets in equities than the British companies. Even the British companies which were organized shortly after the war followed this policy at the time of organization. We have seen that this has been partially due to the greater variety of common shares in our own country, the popularity of this method of financing business organizations, the upward secular trend in business in the United States, and possibly a more optimistic attitude on the part of the American investing public. The large number of American management companies organized during 1928 and 1929 neglected bonds almost entirely. As fast as new capital issues could be sold the funds were placed in common stocks and thus the crash in 1929 caught most management companies unprepared. This failure to anticipate the liquidation phase of the cycle is, of course, another factor leading to the unpopularity of the management type company during the depression years.

This is not to say that all management companies were caught by the crash. A few had wisely (wisely at least from the standpoint of the individual company) placed large amounts in call loans, or were holding funds in cash in the form of bank deposits in anticipation of more favorable buying conditions. A considerable number of companies found themselves just at the time of the crash in the fortunate position of having in their possession large amounts from the sale of capital issues which they had not yet had time to "invest." This group were thus able to save themselves from the late 1929 decline. Nearly all

management companies invested most or all of their idle capital funds in common stocks after the decline of October, 1929. These purchases took place around the November, 1929, "lows." Purchases at this time constitute, in the opinion of the writer, a more justifiable criticism of the results of management than does the failure to forecast the first decline. It is recognized that it is easy to criticize, but it would appear that the declines in September and October, 1929, might have led to greater caution than was actually exercised. A statement in an article by Earl H. Smith in February, 1930, well represents the attitude prevalent during the early months of the depression. In the article Mr. Smith criticized the policy of investment companies organized as affiliates of banks keeping funds in cash on deposit with the banks which sponsored them, drawing only a low rate of interest, "at a time when many of the soundest common stocks in the world were selling at bargain prices that may never be repeated, many even being below or close to book value."⁶

However, care must be taken not to condemn the whole investment-company movement on the basis of a failure to anticipate particular declines or even to adjust portfolios satisfactorily during an entire stock-market cycle. The management investment company as an institution can be judged only in terms of its average record over a long period of time and through several business cycles. The same holds true of every individual investment company. Examples of the failures of management investment companies on specific occasions are given as explanations of the decline in the popularity of this type and the rise to prominence of the contractual type company rather than as a condemnation of the statutory company as an institution.

Managements were slow to adjust their portfolios during the period of liquidation from 1930 to 1932. Only gradually did the ratio of obligations to equities increase, and much of the change occurred during late 1931 and early 1932, at which time an opposite tendency should have been in evidence. At no time during the period did the percentage of obligations in the portfolios of management companies on the average equal 50 per cent, and the highest percentage was reached in 1932. However, in 1933 the inflationary scare, the recurrence of optimism as to the future course of business, and the tendency to invest in common

⁶ E. H. Smith, "Emerging from the Fog," *ibid.*, February, 1930, p. 176.

stocks in accordance with the "common-stock theory of investment" whenever an excuse can be found for doing so, led investment-company managers to shift from bonds to stocks in such volume that in this year on the average management companies were holding nearly as large proportions of stocks in their portfolios as they had in 1929. This situation has resulted favorably, since the trend of common-stock prices since 1933 has been upward. The record of management companies since 1933 has been so favorable that the conclusion must be made that, taking the entire period from 1929 to 1936, ability of the managers of investment companies to shift from stocks to bonds and back again has been of considerable use and value to management investment companies.

In contrast to the management company, the typical contractual type company generally holds either bonds or stocks, but not both. This is particularly true of the unit type, which is predominant in number. Of the unit type the great majority hold common stocks only. There is no opportunity to shift from one class of security to another with different phases of the cycle, reliance being placed upon studies which have shown that over a long period of time common stocks have been superior to bonds as investments. It should be mentioned, however, that acceptance of the theory of common stocks as long-term investments does not justify a portfolio in which only common stocks are permitted.

A number of studies has been made to show that management has justified itself during the depression. These studies have nearly all been made on the basis of a comparison of the net assets of management companies with the stock averages in an effort to show that the former have declined less than the latter in declining markets and have advanced more than the latter in rising markets. All of the studies are subject to certain criticisms and some of them are subject to still others.

In the first place, the adequacy or inadequacy of management cannot be proved by a study of the investment-company movement in the United States. Such studies must be based upon managerial records over a long period of time and on several stock-market cycles. A management may fail utterly during one stock-market cycle and yet over a considerable period of time show a favorable record. Investment companies in the United States have been in existence too short a

time to permit the drawing of conclusions. Studies over the period of time available are useful as indications of conditions and trends but care must be taken not to draw unwarranted conclusions from such meager data.

In no case has a study included all management companies or even a majority of them. This would not be serious if the sample taken for study could be taken as adequate, but doubts arise in this connection. The sample is usually taken on the basis of the size of the companies, the ages of the companies, or the fact that the companies are listed on the New York Stock Exchange or New York Curb Exchange. Taking the large companies as samples does have the advantage of including in the study companies which together aggregate a considerable percentage of the total capital invested in management companies, but it does not aid us in determining what number of companies have had efficient management. Moreover, there is some ground for believing that the large companies have tended to have the most efficient management, since the large volume of investments would enable them to spend more for management and still show reasonable expense ratios.

Selection of the companies for study on the basis of age is likely to give a bias favorable to management. While in many cases the older companies were chosen for study because comparison of the records could be made for a longer term of years, it might be expected that the older companies would have somewhat better management than those more recently organized. The factor of experience should help to bring this about as well as the fact that the older companies were in a position to secure the best available management. By the time the more recently organized companies began to look around for managers, they found the supply already pre-empted by the companies previously organized.

The requirements for listing investment companies on the New York Stock and New York Curb exchanges would likewise tend to indicate that the managements of these companies would show better records than the average for all investment companies. Studies which use samples of this sort do not answer the question as to what has happened to the hundreds of management companies, which the public have at least called investment companies, during the period since 1929. The fact that many of these companies have published inadequate

information about their operations has made inclusion of such companies, however, impossible.

Another criticism of the studies which have been made is that comparison is made between changes in the net assets of investment companies and changes in an average of stock prices. In general no adjustments are made for the fact that some bonds and some cash are found in the portfolios of many investment companies. It is assumed that the portfolio is completely invested in common stocks, whereas this is often not the case. A study which shows that the net assets of an investment company declined slightly less than the average of common-stock prices does not prove the competence of the management if the portfolio consists partly of bonds. When bonds are present the common stocks held might decline much more than the average of common-stock prices and yet the total net assets of the company might decline less than the average of common stocks. The only proper way to judge the adequacy of the individual selections of bonds and stocks would be to compare changes in net assets with an index number of bond and stock prices weighted in the same proportions as bonds and stocks are found in the investment-company portfolio. It may be contended, of course, that the fact that some bonds or cash are found in the portfolio should be credited to management, but it is still true that management cannot clearly justify itself by showing a record only slightly better than the average of common-stock prices during a long period of declining values.

Some of the studies have used one index of stock-market prices during declines and another index during advances. For example, during a period of declining prices, the net assets of an investment company may decline more than the Standard Statistics ninety-stock price index but less than the Dow-Jones industrial-stock price index, while in periods of rising prices the net assets may advance more than the Standard Statistics index but less than the Dow-Jones index. By comparing the total of net assets with the Dow-Jones index during a decline and with the Standard Statistics index during an advance, the investment company can show a favorable management record.

Some studies have compared changes in net assets with changes in stock averages during declines but have compared changes in the market prices of investment-company stocks with changes in stock

averages during advances. The presence of bonds in the portfolio would give a better record than the stock averages during a decline while the leverage factor would cause the price of the investment-company common stock to rise faster than average stock prices.

Recognizing the inadequacies in the studies that have been made—namely, too short a period of time, too few companies, and possible bias in the selection of the data—what do the results of the studies indicate? During the period from 1929 to 1932 the fact that there were some bonds and cash in the portfolios caused the net assets to show slightly smaller declines than took place in the common-stock averages. As the liquidation phase wore on, the continued transfer of funds from stocks into bonds gradually brought about a better record with respect to comparison with the stock averages. Since 1933 the record has been far more favorable. This is partially to be accounted for by the fact that in 1933 the percentage of the portfolios in common stocks increased greatly, but the fact that a part of the portfolios still consists of bonds and preferred stocks should have caused the net assets to rise less rapidly than the stock averages. Actually average net assets have increased about as rapidly as the stock-market averages, which indicates wise selections on the part of the managements.⁷ However, appreciation in the prices of bonds and preferred stocks has also partially accounted for the favorable record.

The two principal features offered by the investment company are management and diversification. Another important difference between the statutory type and the contractual type is in the extent and nature of the diversification found in the portfolio. Again, however, it

⁷ A study of the 1935 portfolio records of 40 management companies (22 of the leverage type, 5 of the nonleverage type, and 13 of the mutual fund type) shows that 22 of the 40 companies produced better investment results than would have been achieved had they invested in the 70 stocks included in the three Dow-Jones common-stock averages. Of the 40 companies, 38 had a better record than the individual would have accomplished who placed 50 per cent of his funds in the Dow-Jones 70-stock average and 50 per cent in the Dow-Jones bond average. The 22 leverage companies showed an average gain in total net assets of 51.1 per cent as compared with gains of 39.7 per cent for the nonleverage companies and 38.0 per cent for the mutual funds. This is surprising in view of the fact that the leverage companies have larger proportions of their assets in bonds and preferred stocks than the other two types. See Eliot Sharp and A. A. Winston, "Investment Trusts Tested," *Barron's*, March 2, 1936, p. 7.

is found that the differences between the direct and contractual type are no greater than the differences between American companies as a group and British companies. Investment-company theory assumes a considerable degree of diversification on four bases—geographical, industrial, numerical, and by type of security. The British companies have followed a policy of wide diversification in all four respects. Portfolio holdings are generally distributed among from 200 to 800 different securities. A large number of industries is represented in the typical portfolio, and bonds, preferred stocks, and common stocks are found. In addition, British companies invest in securities originating in every part of the world, with some evidence of concentration in securities originating in the British dominions and dependencies and in the United States, Continental Europe, and Argentina.

The typical American management company does not hold so many different securities as its British counterpart. We have already seen that the proportions of common stocks to the total portfolio holdings are much larger in the case of American companies than in Great Britain. Many American management companies are of the specialized type, investing their funds in only one industry, while those that are of the general type often show a narrower diversification than do the British companies. It is with regard to geographical diversification that the American companies show the greatest difference from the British companies. The latter developed as a method of facilitating the export of capital from Great Britain and as a means of making available to the small British investor foreign investments with higher yields than domestic investments, and as an attempt to reduce the risks involved in foreign investment through the use of the principle of diversification. During the period immediately following the war it was expected that the investment company would develop in this country with objectives similar to those of the British companies—namely, to take advantage of higher interest rates in other countries than existed at home. The fact that the United States had just become a creditor nation added to this expectation. During the decade of the 1920's the export of capital took place in vast amounts, but through the direct sale of foreign securities in this country rather than through the medium of the investment company. The dominance of the common-stock theory of investment and the speculative boom in common stocks led to the

concentration in investment-company portfolios of the common stocks of a relatively small number of American companies in a limited number of industries. Foreign securities were neglected by all but a few companies and almost no companies have achieved the wide geographical diversification which is standard in Great Britain.

The typical contractual investment company in the United States has in its portfolio about thirty common stocks. Many of the specialized companies have fewer than this number, while those companies which hold bonds in their portfolios usually have more than thirty securities. With regard to diversification as to security types, we have seen that both the management and the fixed companies have tended to concentrate in common stocks. The management company, while it is able to shift its portfolio from bonds to stocks and back again as the business-cycle phase changes, has not fully taken advantage of its opportunities to do so.

Only a few examples have been found of investment companies of the contractual type which make a practice of holding both bonds and stocks in their portfolios, and nearly all of them are in the fund group and are of the management type. Even in those which hold some bonds, common stocks represent a far larger percentage of the total portfolio value than do bonds, even during the liquidation phase of the cycle.

One case has been found in which a company has followed the policy of holding 50 per cent of its portfolio in United States government bonds and 50 per cent in common stocks. One of the original series of Keystone Custodian Funds, now out of existence, followed this practice. In this case, however the 50-50 ratio was maintained whatever might be the state of the business cycle, so that the policy of the company was of little significance as exemplifying adjustment to changing business-cycle trends. Some adjustment took place, however, through the fact that if bonds were going down in price more, or were going up in price less, than the prices of common stocks, this would tend to cause the percentage of the funds invested in government bonds to be less than 50 per cent, and adjustment was made to bring the figure back to the 50 per cent point by investing in government bonds additional sums coming into the fund for investment, while investors who were withdrawing from the fund were paid out of

the proceeds from the sale of common stocks. The opposite procedure was followed if common stocks were going down in price more or were going up in price less than government bonds. This policy resulted in the purchase of that type of security which was lower in price with respect to the other and the sale of that type of security which was higher in price. The situation was one in which a security was purchased when its price was low and sold when its price was high. This policy, it should be recognized, is an exception in the case of the contractual type company.

A few contractual companies have diversified as between preferred stocks and common stocks, but in most cases preferred stocks have been in the minority. The original series of United States Electric Light and Power Shares was established with equal dollar diversification between preferred and common stocks.

The management company, in criticizing the fixed company for its narrow diversification, must recognize that, to the extent that there is a difference in diversification practices of management companies and fixed companies, it is only a difference of degree and not of principle. The fixed-company portfolio has failed to provide broad diversification in all elements, but so also has the American management company, and in only slightly less degree.

The fixed contractual investment company, however, emphasizes the diversification factor, omitting the management feature except in so far as the original choice of securities is concerned. The semifixed company likewise stresses diversification, but includes the managerial function both in the choice of securities for the portfolio originally and in the matter of eliminations and, sometimes, substitutions during the life of the company. On the whole, however, the contractual investment company relies for its economic existence chiefly on the furnishing of diversification, usually in common stocks. Before the wholesale passing of dividends occurred in 1931 and 1932 one of the principal selling points of fixed and semifixed company sponsors was that the diversification provided to a great extent the inherent safety of bonds while retaining the attractive features of common stocks.

In the case of those companies providing considerable discretion in the management of the portfolio, one advantage which has been presented is that the contractual investment company makes it

possible for the small investor to secure the same type of management of his fund as that ordinarily obtained only by individuals and institutions having large sums to supervise. This point has been much used in the advertising of those companies sponsored by investment advisory services. The commingling of the funds of many small investors makes possible the accumulation of a sum that can be managed as efficiently and economically as the funds of particular individuals and the funds of estates. Economic Analysts, Inc., for example, advertises that while the average account which it manages is about \$5,000,000, the establishment of Mutual Custodian Accounts, a contractual type company, represents an attempt to extend the benefits of managerial service to those having between \$200 and \$100,000 to invest. The feature of management of the funds of the small investor applies in general, however, much more to the statutory than to the contractual type company. The only essential difference between the two types in so far as management is concerned is the trusteeship of the property in the case of the contractual company.

The following excerpts from the literature of contractual type companies indicates the advantages which such companies purport to offer so far as diversification is concerned:

One corporation or one industry may prosper more than another, but spreading the investment over a considerable number of strong corporations engaged in diverse lines of endeavor, safeguards Principal and steadies Income. As Canada prospers and grows there is the assurance that the value of this investment will rise and that dividends will increase. . . .

The investor is in possession of an undivided beneficial interest in a wide list of securities selected as the result of the skill, knowledge and judgment of financial authorities familiar with such matters.

As a result, he receives the benefit of true diversification which minimizes investment risk and enhances certainty of income and the possibilities of increase in the value of the investment.

Possessing a well-balanced, sound and dependable investment he provides a source of income and wealth for himself and his heirs which needs no special knowledge or skill to administer.

. . . . They give to the small investor the same benefits generally available to the large investor and they give to the large investor greater freedom

from care and lower cost of administration than is generally obtained through other methods.⁸

Three major factors should be provided if a composite investment is to enjoy true and complete diversification and correct balance. These are: (1) the number of dollars invested in each stock should be as near an even percentage of the total fund as possible; (2) industrial diversification; (3) wide geographical diversification.⁹

Diversified Trustee Shares, Series "D," represent beneficial interests in a diversified group of common stocks of . . . leading corporations and are designed to afford to investors a convenient medium of diversification in selected common stocks.¹⁰

Since the market prices of certain stocks in the unit are higher than those of others, the value of each stock held is equalized to some extent by including in each unit varying numbers of shares.¹¹

The holder of London International Trustee Shares is assured of safety of principal by the care that has been taken to provide the greatest possible diversification.¹²

Contrasting the American management company with the fixed or semifixed company, we find that the former provides a greater degree of diversification in number of securities, but not always greater diversification with regard to industries represented nor with respect to geographical diversification. In so far as number of securities is concerned, the contractual-company sponsor claims that thirty companies represent an adequate diversification, particularly when it is considered that when these thirty securities are issued by the large companies, the leaders in their respective industries, very large amounts of capital and extensive undertakings are involved in each security held. Also, it is pointed out, many of the companies whose securities are found in the portfolios are holding companies which control many other companies in the same industry. The sponsors of the contractual companies point out that management companies,

⁸ *All-Canadian Common Stock Trust Shares*, Ser. "A" (circular), December, 1930, pp. 1-2.

⁹ *American Composite Trust Shares* (prospectus), ca. 1930, p. 2.

¹⁰ *Diversified Trustee Shares*, Ser. "D" (prospectus), September 17, 1934, p. 1.

¹¹ *Business Recovery Trust Shares* (prospectus), February 9, 1931, p. 2.

¹² *London International Trustee Shares* (prospectus), 1931, p. 2.

which are more prone to place funds in "special situations"—smaller companies in which they are interested—are taking a greater risk and need the diversification involved in a larger number of companies represented in the portfolio. They likewise contend that the inclusion of but thirty securities in the portfolio makes it possible to devote greater care and study to their original selection and to give more careful consideration to the question of the advisability of the elimination of any particular security.

Charles F. Speare, in an article entitled "Investment Trusts and Others" in the *Commercial and Financial Chronicle* for December 7, 1929 (p. 3529), wrote as follows:

My impression is that in order to establish the investment trust firmly in the American mind the diversification principle was too much "touted," so to speak, and that there is now a reaction from it. One of the best managed trusts with which I am acquainted finds it has enough units to deal with and watch over in 40. Others have 100 to 200. It is possible to spread the risk very thin in dollars but to have so many and diverse conditions to consider, both national and international, that the whole body of securities may be neglected.

Mr. Speare might have added that one may be so busy studying particular securities that he forgets to study the economic situation as a whole.

When the proponent of the management company complains that the contractual company involves inadequate diversification as to numbers of industries represented, the sponsor of the latter again counters with the argument that the most important industries are included in the contractual investment company portfolios, that the industries some securities of which are included in the portfolios represent a very large percentage of all the productive activity of the nation, and that this factor of concentration in the most important industries gives an inherent stability which reduces the need for representation by a large number of industries. It is further contended that the management company in seeking out special profit-making opportunities is more likely to invest in industries which will prove ephemeral, and thus needs to place funds in a greater variety of industries because of the greater risk taken.

A great deal of discussion has occurred with regard to the extent of

geographical diversification which the portfolio should contain. The two parties to this discussion, it should be understood, are the British management companies, which favor wide geographical diversification, and the American companies, both management and fixed, which invest largely in domestic securities. The American direct type and American contractual type companies are essentially similar in their emphasis upon securities of American origin.

The theory of wide geographical diversification is based upon the principle that some countries are in the prosperity phase of the cycle at times while other countries are in depression. Thus the securities markets of some countries offer favorable buying opportunities at the same time that it would be considered wise to sell securities in the markets of other countries. The investment company following a policy of wide diversification by countries is thus supposed to be enabled to sell in an inflated market the securities of companies in countries where prosperous conditions are existent and use the funds to purchase securities in the countries where conditions are depressed.

To the extent that this situation holds, it is inapplicable to the fixed and semifixed companies, which are unable to sell one security at will and use the funds for the purchase of another security. In addition, some doubt exists as to whether the sale of securities in one market and their immediate use for repurchase in another market can produce such desirable results as the theory assumes. In spite of the striving toward national self-sufficiency, economic interdependence seems to be pursuing its inexorable course. During the past century, when nations were less closely connected commercially, some periods of crisis and of prosperity were national rather than international in scope. This has not been the case so far in the present century. A study of several securities markets in different countries over a period of recent years, made by Rexford C. Parmalee in his study of *The Position of the Investment Trust in the Exportation of Capital*¹³ shows a quite close correspondence between the movements of securities prices in the different markets. If this situation is to continue it would render impossible the profitable sale of securities in one market and the contemporaneous purchase in another market to take advantage of different phases of the cycle in the two markets.

¹³ Unpublished doctoral thesis, University of Illinois, 1933.

Investment companies in the United States have contended that the holding of exclusively American securities represents a much wider geographical diversification than would be the case if a British company were to hold only securities originating in England. They point to the greater geographical extent of the United States as compared with England and the greater variety of industries and of economic conditions represented. They indicate, further, that many of the large American corporations whose securities are held in investment company portfolios have Canadian subsidiaries or interests in Canadian companies, and thus the diversification represented by the securities takes in practically the entire North American continent. This is true of a considerable number of large American companies which have been most popular in fixed-company portfolios, particularly American Can Company, American Smelting & Refining Company, Borden Company, E. I. du Pont de Nemours & Company, General Electric Company, National Biscuit Company, International Harvester Company, Union Carbide and Carbon Company, Standard Oil Company (New Jersey), United States Steel Corporation, Westinghouse Electric Manufacturing Company, and F. W. Woolworth Company. Some enthusiasts refer to the fact that some American companies have connections with foreign companies, or own plants in other countries, or have an extensive foreign trade, and thus their securities represent a diversification which is international in scope. However, American companies whose business is not predominantly domestic are rare and the business of most British companies is of a more international character than that of American companies.

A number of sundry advantages of the contractual investment company have been cited. During 1930 and 1931 fixed companies stressed in their advertising the fact that the investor knows exactly in what securities his funds are placed. Also the facts that the underlying securities were deposited with a bank or trust company as trustee, and that the investor was thus protected against corrupt managements, were often found as advantages. The stressing of these advantages was a direct result of the "flight from management."

It was also pointed out that time and effort are saved the investor, since the duties of receiving and cashing dividend checks on the underlying securities, the signing of proxies, and the disposing of stock

dividends and subscription rights are assumed by the custodian. The investor does not need to undertake continuous investigations of the underlying securities, since the investment counsel takes care of this. The investor in some cases saves on the items of brokerage charges and odd-lot fees by purchasing participating shares. He is saved time and trouble in the storage of securities. He is not required to send out so many notices of a change in address. In settling the estate of a deceased holder, participating certificates afford certain advantages in contrast with direct ownership of stocks, among which are the avoidance of preparing and filing numerous documents, the elimination of delays and excessive costs, the ability to sell promptly all or any part of the certificates, the ease of division of the certificates among those entitled to receive them without the necessity of sale, and the saving of administrative costs, and in some cases in inheritance taxes, by avoidance of duplication. It is claimed that the difficulties incident to the probating of an estate where there is a direct holding of a group of common stocks is avoided by the holding of participating certificates. The transfer of registered stock certificates to the heirs, or the liquidation of the stock into cash, is usually a complicated and expensive undertaking. Usually the services of an attorney or trust officer are necessary and this often constitutes a considerable expense to the estate. These advantages are especially designed to appeal to the man of wealth, since such an individual has sufficient funds to provide his own diversification.

It is the opinion of the writer that one of the chief advantages of the contractual type company has been stressed far too infrequently in the literature and has been stressed practically not at all by the companies in their advertising. This latter fact is probably partially to be accounted for by the belief that its recognition would react detrimentally upon the ego of the prospective investor. The argument is used, however, by Tobacco Trust Shares, Series "A" and "AB," in a booklet published by the company. The following statement is made:

Protection Against Oneself: The strength and security of the group type of investment is based upon the diversification of the holdings and their relationship to one another. The investment must comprise a good group at the outset—and the group must thereafter be kept intact. But when the stocks are individually held, this is apt not to be so. Sooner or later the

holder begins to watch quotations on the individual stocks and finally sells one of the group and buys some other stock which at the moment appears more attractive. Instead of a properly related group holding he finally holds merely a list of stocks—a confused scattering of his funds. The trust form of holding protects the investor against the hazards of in and out trading. It protects him against himself.¹⁴

The contractual type company is a device whereby the small investor can purchase and hold common stocks without making of himself an amateur trader endeavoring to catch the short swings. The investor does not need to subject himself to all the unfortunate results which almost inevitably accrue to the small in-and-out speculator. The holder of participating certificates of a contractual investment company is more likely to purchase them as he would a high-grade bond, for long-term investment, and to disregard short-term fluctuations in the price of the investment-company shares. There is less news in his daily paper about the investment company whose shares he is holding than there is about the companies whose shares are being held in the investment-company portfolio, and the daily quotation on the investment-company shares is likely to be somewhat more difficult to obtain. Moreover, since most contractual investment company shares are low priced, changes occur only in fractions of a point and this does not seem so serious to the investor, even though the percentage change may be considerable. The investor only dimly realizes that as the prices of the securities held in the portfolio go up or down the value of his investment moves correspondingly, and thus he feels less elation during a bull market and less dejection during a bear market. The result is likely to be a decrease in the tendency to buy and sell at the wrong time.

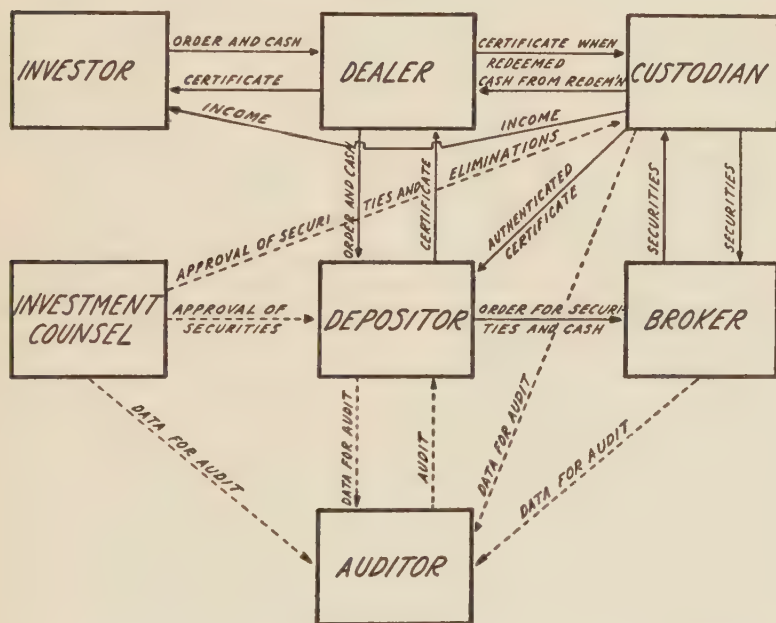
¹⁴ *Tobacco, Its Human Appeal and Investment Value* (1934), p. 7.

CHAPTER IV

STRUCTURE AND METHODS OF OPERATION OF CONTRACTUAL INVESTMENT COMPANIES

It is desirable as an introduction to this chapter to indicate briefly the parties and institutions involved in the operation of a contractual type investment company together with their major functions. These

CHART I



relationships may be made clear by means of Chart I. The interconnecting solid lines indicate the transmission from one agency to another of cash or securities; the dotted lines indicate the transmission of data and information.

The term “contractual” refers to a particular legal form of organiza-

tion of the investment company and this study is concerned with all investment companies which take this legal form. The term differentiates that group of investment companies which we are studying from all other types.

The legal form gives rise to certain problems of organization and management, particularly with regard to the rights, powers, and duties of the parties to the contract. We are not, however, concerned only with the legal form, since other features of the investment-company problem are fully as important, or more important under certain circumstances. Questions relating to the investment policy of the company, the degree of management provided, the efficiency shown by the management, and the types of securities issued constitute a better measure of the worth of the investment company to the individual investor and thus (though perhaps not always) to the economic system than the particular legal method of organization which is used.

A contractual type investment company, as we have seen, results from the making of a contract usually involving three parties, (*a*) the depositor, who deposits securities, cash, and other property with (*b*) an agency generally called a "trustee," but herein designated as a custodian, which holds the property placed in its charge by the depositor for the benefit of (*c*) the certificate-holders, sometimes called beneficiaries, who hold equitable title to the property deposited with the custodian. It has been pointed out that the execution of this agreement often, but not always, creates a trust. The agreement as drawn up generally designates a trust company as a depository of the securities against which participating certificates are issued. The work of the trust company is largely clerical in nature, even though this party to the contract often does hold legal title to the deposited property. The custodian almost always has only extremely limited rights or duties in connection with the management or supervision of the deposited property, all changes in the property being made by the trust company only at the direction of the depositor acting under the terms of the indenture.

THE CERTIFICATES

The first article of the indenture quite commonly deals with matters relating to the issue and authentication of certificates representing participating shares of the investment company. In the case of the

unit type it is stated how many shares shall constitute a unit, and a maximum may be placed upon the number of units which may be issued by the company. One thousand shares and two thousand shares per unit are common figures. The denominations of certificates vary according to the number of shares issued per unit, but the most usual denominations are for five, ten, twenty-five, fifty, one hundred, five hundred, and one thousand shares.

The price per share at which certificates are offered to the investing public is a very important matter, since it involves questions of the spread between the price which the investor has to pay and the value of the share as a proportionate part of the deposited unit or fund.

During the early period of contractual investment company development, many companies did not explain with sufficient care in their offering circulars the methods used in computing the offering prices. At first, also, there was little standardization in procedure. Now, however, partly as a result of regulatory action by the New York Stock Exchange and the Securities and Exchange Commission, considerable standardization is found in the formulae used. Many minor variations occur, but the basic formula is now uniformly set forth in the prospectus and indenture of the company for the perusal of the investor, if he is interested.

The offering prices of participating shares bear a close correspondence to the value of the unit or fund on the basis of which they are issued. This results from the fact that changes in the value of the unit or fund are the principal factor influencing changes in the offering prices of the certificates.

In general the offering price per share from day to day is computed as follows. The total value of a unit is obtained by adding (1) the total market value of the deposited securities in the unit, obtained by totaling the products of the number of shares of each security in the unit by the closing market price or asked price per share for each security, (2) the total odd-lot premiums, secured by adding together the items resulting from the multiplication of the odd-lot premium applicable to each security by the number of shares of the security held, (3) the total buyers' taxes, obtained by adding the separate items of taxes applicable to each security in the unit, and (4) the total brokerage commissions, obtained by adding the separate commissions

required to be paid in the purchase of each security in the unit. This procedure gives the total value of the underlying securities, or the total value of the stock unit. This figure is divided by the number of shares or certificates issuable per unit, which gives the value per share. To this figure the "loading" or service charge is added as a percentage either of the value of the stock unit per share or as a percentage of the final selling price per share. After the addition of the "loading" charge, the proportionate value per share of any cash and other property in the surplus fund or reserve fund, and the value per share of accumulations since the last distribution date, are added. The amount obtained by this process represents the offering price per share, except that in practice the price is often adjusted to the nearest or next higher cent or fraction of a dollar per share, since in the computation, as indicated above, extension to several decimal points is often involved.

Practice before 1931 usually involved the adjustment of the computed offering price to the next higher eighth, but thereafter established practice was quite generally dictated by the recommendations of the New York Stock Exchange which required that in the computation of the offering price adjustment to the next higher cent might occur if the price per share were \$1.00 or less, adjustment to the next higher one-twentieth of a dollar if the price were more than \$1.00 and less than \$5.00 per share, and adjustment to the next higher eighth if the price were \$5.00 per share or more.

The price-makeup sheet for a company of the fund type is similar to that for the unit series type, except that the computation is carried out on the basis of the entire fund rather than in terms of units. The offering price per share is an amount equal to the quotient obtained by dividing the net value of the fund by the number of shares into which the fund is then divided. The net value of the fund is determined by deducting from the aggregate market value of the securities and other property (including cash, accrued interest and dividends declared but not paid), all unpaid charges against income and principal. The market value of the securities may be computed on the basis of market prices or asked prices. The offering price is adjusted upward by the percentage of the "loading" charge and may then be adjusted upward to the nearest eighth or to the nearest cent.

There is given in Table 5 a typical price-derivation or makeup sheet.

THE LOADING CHARGE

A wide variation is found between the lowest and highest loading charges. The attorney-general of the state of New York in his report

TABLE 5*

PRICE MAKEUP, CLOSING PRICES, JULY 31, 1935
(DEPOSITED BANK SHARES, NEW YORK—
SERIES "A")

	No Shares per Unit	Total Value of Under- lying Stocks
Bank of the Manhattan Co.....	40	\$ 1,055.00
Bank of New York & Trust Co.....	6	2,838.00
Bankers Trust Co.....	30	2,164.00
Central Hanover Bank & Trust Co.	12	1,572.00
Chase National Bank	30	979.00
Chemical Bank & Trust Co.....	60	3,030.00
Corn Exchange Bank Trust Co.....	25	1,397.00
First National Bank of New York.....	1	1,725.00
Guaranty Trust Co. of New York	7	2,198.00
Irving Trust Co.....	90	1,395.00
Manufacturers Trust Co.....	23	670.00
National City Bank.....	54	1,647.00
New York Trust Co.....	18	2,032.00
Public National Bank & Trust Co.....	45	1,637.00
United States Trust Co.....	1	1,910.00
Total underlying†.....		\$26,249.00
Surplus fund also invested‡.....		8,077.00
Value of one unit of underlying stocks (exclusive of accumulations).....		\$34,326.00
Value of underlying stocks per Deposited Bank Shares New York—Series "A"		2.288
Overwriting per share 8.7 per cent of value of under- lying stocks (equivalent to not over 8 per cent of offering price)		.199
Income account per share		.048
Total		\$ 2.535
Offering price per share		2.550

* Indicating composition of the trust properties, surplus fund, and accumulations. No component part of the offering price consists of brokerage commissions, odd-lot premiums, or other items of expenditure other than the service or loading charge.

† Underlying stocks valued at current offering price.

‡ Consisting of \$73.39 cash and 3497.7 trust shares valued at current offering price of the stocks underlying same.

on investment companies as made by the Bureau of Securities of the state and published in 1927, indicated the spread to vary from 10 to 20 per cent.¹ Cases as high as 20 per cent have existed but in general it may be said that the lower limit as given in this report is much nearer the upper limit. Clarence Starr in an article in *Keane's Investment Trust Monthly* for January, 1931 (p. 10), gave the range as from $7\frac{1}{2}$ to 35 per cent. Actually the loading charges of the different companies are very difficult to compare except where the companies have been required to answer a question with regard to the spread in which the same formula must be followed in the method of computation. It is impossible to compare the loading charges as given in the literature of the companies because of the differences in the bases of computation. Many of the companies use closing market prices while others use closing asked prices; some add in reserve funds before computing the percentage "load" and others do not; some quote the "load" as a percentage of the offering price of participating shares and some as a percentage of the prices of the underlying securities; some have two charges, one for issue and deposit and another for distribution and profit. In addition, some companies have only a small initial loading charge but derive additional compensation from a semiannual fee taken out of currently distributable funds before distribution to the certificate-holders. Others, particularly of the investment contract type, have no initial charge at all but take all compensation out of income in the form of a percentage of the value of the fund or of the amount of the income. A further explanation of periodic charges will be made in connection with the discussion of compensation of the depositor. The matter is only mentioned here to enable the reader to visualize more easily the complexity of the situation.

It is to be expected that there will be some variation in the loading charges of different companies based upon differences in services for which the loading charge is considered compensation. In a few cases

¹ See State of New York, *Investment Trusts (A Survey of the Activities and Forms of Investment Trusts with Recommendations for Statutory Regulation by the New York State Department of Law)* (1927), p. 43. At another point in the report (p. 62) it is stated that "the differential between the cost of the underlying securities and the asked price ranges in the case of the various companies between 7 and 15 or 16 per cent."

a higher-than-average loading charge is justified by the larger-than-average number of securities included in the portfolio. The investor pays for a greater degree of diversification. Some depositors exercise a greater amount of supervision over the portfolios and where compensation for this supervision is not derived from periodic charges out of income, a higher "load" is justified. If a company is expected to run for a longer time than the average, a higher "load" will be charged because the investor secures the service for a longer time.²

The highest loading charge which has been found is that for Royalty Income Shares, Series "A." In determining the cost of the deposited property on which the "load" is based, a $7\frac{1}{2}$ per cent charge is added to the actual cost. While this is considered as a part of the cost of the deposited property, actually it is a charge which covers expenses normally absorbed in the loading charge and therefore may properly be called a part of such charge. In addition, "the Trust Agreement provides for a surcharge of 25 cents per share to cover the selling costs and profit of the underwriter and associated dealers for the distribution of trust shares."³ Since the cost of the underlying property per share is \$1.00, this 25 cent surcharge represents a 25 per cent loading charge on the value of the deposited property. The $7\frac{1}{2}$ per cent plus the 25 per cent makes up a total loading charge of approximately 35 per cent. It should be remembered, however, that this is a special type of contractual investment company in which the portfolio consists entirely of oil-royalty interests and related items and that such a portfolio presents special problems. Other companies with portfolios of similar securities have total loading charges about the same as Royalty Income Shares, Series "A." Of those companies having corporate securities in their portfolios, the highest loading charge that has been found is 11.1 per cent based on the market value of the underlying property.

Table 6 indicates the "loads" as given for thirty-nine companies in data in Durst's *Analysis and Handbook of Investment Trusts*.⁴

It is important to note that the size of the loading charge can be

² See *Barron's*, September 2, 1931, p. 18.

³ *Royalty Income Shares, Series "A"* (digest of principal features; 1935), p. 4.

⁴ See Durst, *op. cit.*, pp. 301-66.

judged only in terms of the length of life of the company. In those cases where the initial loading charge is the only charge made to the investor over the life of the company, the investor is prepaying the company for the service he expects to receive over a long term of years. The adequacy of the loading charge, therefore, can be judged only in terms of the number of years' service which the investor is securing for the payment he makes. The necessity of dividing the initial loading

TABLE 6
LOADING CHARGES BASED ON PERCENT-
AGE OF MARKET VALUE OF UNDER-
LYING SECURITIES FOR 39 INVESTMENT
COMPANIES, 1931

Percentage of Market Value of Underlying Securities	Number of Companies
5.50- 5.99.....	1
6.00- 6.49.....	0
6.50- 6.99.....	0
7.00- 7.49.....	1
7.50- 7.99.....	1
8.00- 8.49.....	10
8.50- 8.99.....	6
9.00- 9.49.....	7
9.50- 9.99.....	11
10.00-10.49.....	2
Total.....	39

charge by the number of years which the company plans to run in order to reduce the charge to the investor to an annual basis is thus apparent. In connection with the regulation undertaken by the New York Stock Exchange in 1931 data were secured from companies indicating the total loading charge as a percentage of the underlying securities and in addition these data were reduced to a "load-per-year" basis. The data have been reproduced in Table 7. It will be noticed that the highest annual "loads" are, in general, those for companies which were inaugurated to run for only a few years. The table includes forty companies, all of which were on the original "unobjectionable" list of the New York Stock Exchange.

TABLE 7

LOADING CHARGES, TOTAL AND PER YEAR FOR 40
CONTRACTUAL INVESTMENT COMPANIES OF UNIT
SERIES TYPE, 1931

Name of Company	Loading Charge Percentage of Under- lying Securities	Loading Charge Percentage Per Year
ABC Trust Shares, Series "D"	9.06	0.48
ABC Trust Shares, Series "E"	8.98	3.59
All-American Investors Trust Shares	8.69	0.30
American Composite Trust Shares	8.00	
Business Recovery Trust Shares	8.00	1.60
Collateral Trustee Shares	10.42	0.63
Corporate Trust Shares (Original)	9.00	0.40
Cumulative Trust Shares	9.50	0.50
Deposited Bank Shares, Series "A"	8.70	0.36
Deposited Insurance Shares, Series "A"	8.70	0.36
Diversified Trustee Shares, Series "C"	7.00	
Diversified Trustee Shares, Series "D"	8.13	0.56
Equity Trust Shares in America	8.00	0.42
First Bank Trust Shares, Series "B"	9.00	0.95
First Custodian Shares	8.75	0.46
Fundamental Trust Shares, Series "A"	8.50	0.44
Fundamental Trust Shares, Series "B"	8.50	0.44
Independence Trust Shares	8.00	0.42
Leaders of Industry Shares, Series "C"	9.56	0.39
Low-Priced Shares	8.50	1.88
Nation-Wide Series "B" Trust Certificates	9.50	0.51
National Industries Shares, Series "A"	7.25	0.31
National Industries Shares, Series "B"	8.00	0.55
National Trust Shares	7.00	0.36
New York Bank Trust Shares	8.70	0.36
North American Trust Shares (1953)	9.50	0.42
Public Service Trust Shares, Series "A"	9.50	0.51
Representative Trust Shares	5.50	0.58
Selected Managements Trustees Shares	10.00	1.50
Super-Corporation of America Trust Shares, Series "A"	8.11	0.90
Super-Corporation of America Trust Shares, Series "B"	8.11	0.90
Super-Corporation of America Trust Shares, Series "C"	8.11	0.46
Super-Corporation of America Trust Shares, Series "D"	8.11	1.08
Trusteed American Bank Shares, Series "A"	9.50	0.19
Trusteed New York Bank Stocks	8.69	0.36
Trust Fund Shares	9.50	0.51
Trust Shares of America	8.00	0.84
Twentieth Century Trust Shares (Original)	9.00	1.06
Two Year Trust Shares	9.34	6.22
U.S. Electric Light & Power Shares (Series "A")	9.50	1.12

The Securities and Exchange Commission has also made some effort to standardize the basis for the publication of the loading charge in order to facilitate comparison on the part of the investor. The company is required to include in the registration statement and to publish in the prospectus information in answer to the following item:

State the "service" or "loading" charge in terms of a percentage of the actual market value of the underlying securities, as of a date within 15 days prior to the filing of this registration statement. If odd-lot premiums, commissions, or the like, are included in the determination of the market value of the underlying securities, make a specific statement to that effect, explaining concisely the basis upon which such premiums, commissions, or the like are computed.

A study of the companies which have filed statements with the Commission makes possible the conclusion that those companies which had sold certificates before the Securities Act of 1933 went into effect had an average "load" based on the foregoing formula of between 9 per cent and 10 per cent. However, those companies which were just being organized and which had not yet sold certificates were unable to give this information, since no property had yet been placed in the portfolio and therefore the loading charge could not be given as a percentage of the actual market value of the underlying securities. For example, Mineralwealth Fund indicated in answer to this item: "Since at the time of filing this registration statement no properties had been deposited with the Trustee, the actual market value thereof cannot be stated or estimated."⁵

THE DEPOSITOR

The depositor may take any legal form. It may be an individual, a partnership, a joint-stock association, a Massachusetts trust, or a corporation. Actually most of them have been and are corporations, largely because of the ease with which the ownership can be broken up into transferable shares.

The duties of the depositor may be summarized as follows:

1. Drawing up the indenture. The terms of the indenture are decided upon by the officers in consultation with their attorneys, and with the custodian and its attorneys. The actual writing is done by the attorneys.
2. Execution of the indenture.

⁵ *Mineralwealth Fund, Registration Statement, Item 38.*

3. Maintenance of a research and statistical staff to study various matters such as original selection of securities for the portfolio, the advisability of eliminations and substitutions, etc., also to study the matter of arranging the company structure, such as whether or not a reserve fund shall be used, and whether the company shall be of the capital accumulation or maximum distribution type.
4. Purchase of securities and other property for deposit through members of an organized securities exchange or otherwise.
5. Deposit of units of deposited property with the custodian.
6. Preparation of certificates, presentation of certificates to the custodian, and receipt of authenticated certificates from the custodian.
7. Administration of distribution of certificates, such as the making of dealer contracts, computation of the offering price, receipt of confirmation of sales, shipment of securities to distributing dealers, receipt of sales proceeds, and preparation of statements necessitated by these functions. In many cases, certificates are simply delivered to a wholesale distributor which takes over many of these functions.
8. Distribution of the sales price of participating certificates to the proper parties. The loading charge is distributed in various proportions in accordance with the terms of the indenture, to the dealer, the depositor, and the custodian. The difference between the loading charge and the sales price is kept by the depositor as a part of its working capital for future use in the purchase of additional units of deposited property.
9. Preparation of prospectuses, sales literature, and advertising material. Making contracts for the printing of indentures, prospectuses, and sales literature. Making contracts for newspaper and magazine advertising. Shipment of advertising material to distributing dealers. Arrangement of advertising allowances with dealers.
10. Co-operation with attorneys for the depositor in defending the company against lawsuits and other litigation.
11. Co-operation with attorneys in securing approval for the sale of securities from federal, state, and local agencies.
12. Arranging for a periodic audit of all accounts of the depositor and custodian through making a contract with a firm of certified public accountants.
13. Preparation and printing of periodic income-distribution statements to accompany distributions made by custodian.
14. Issuance of reinvestment rights.
15. Administration of tax matters. Preparation of reports required by taxing authorities, payment of taxes, preparation of statements of tax information for certificate-holders.

16. Publication of information as to paying agencies appointed by the custodian.
17. Performance and administration of all clerical and accounting work necessitated by the foregoing functions.

The depositor in the contractual type investment company looks for its compensation primarily to either or both of two sources, the initial loading charge, a part of which the depositor may receive, or an annual maintenance charge payable out of income or principal of the deposited property. The depositor in the typical fixed type company generally secures its compensation from the former of these two sources. In the semifixed type, where provision is made for continuous supervision of the portfolio by the depositor, the loading charge is designed to cover the original expenses of the depositor and an annual maintenance charge is provided to take care of recurring expenses in connection with the supervision function.

THE CUSTODIAN

In the development of the contractual type company the custodian has come to have greater importance. Banks have tended to standardize their contractual relations with depositor corporations and have assumed more management functions. A number of factors have brought about this change. As the movement developed, trust companies took a greater interest in the business and worked out techniques for the administration of additional functions. Important increases in the volume of personal trust business handled by trust companies caused these institutions to be more willing to accept the custodianship of investment companies, since the two types of business had some points of similarity. The tendency for depositor corporations to go out of business caused students of the subject to realize that only by placing greater responsibility for the continuance and permanence of the company upon the custodian could the certificate-holder be protected. This consideration led to the adoption of the principle that the custodian should carry on the functions of the depositor with respect to deposited units if the latter should go out of business. This has actually happened in a number of cases, and the importance of the custodian thus has been increased.

Greater discretionary powers in connection with elimination pro-

visions have been placed upon the custodian. In some cases no elimination can take place without the approval of the custodian and in some no elimination shall take place except with the approval of independent investment counsel appointed by the custodian. All investment counsel appointed by the depositor must be satisfactory to the custodian. Thus it has come about that the investor looks more and more to the custodian to insure the permanence of the company and the continuance of the administration and the depositor tends to limit itself to clerical matters and to the merchandising function of the sale of certificates. The investment company of the contractual type takes on more of an appearance of a personal trust than formerly, but it is still undesirable to designate the investment company as an investment trust.

One trust company generally acts as custodian, transfer agent, and registrar, although in a few cases the three functions are performed by separate banks or trust companies. The great majority of custodians are trust companies or the trust departments of commercial banks, but a few exceptions are found. In one case a certified public accountant fills this office.

Contractual investment company indentures vary greatly as to the division of duties and responsibilities between the custodian and the depositor, but the following items summarize the duties usually assumed by the former.

1. Receipt, checking, and retention of the deposited property.
2. Authentication of and issue to the depositor of participating certificates.
3. Making of sales required to be made by the terms of the indenture. Approving eliminations of deposited property or appointment of investment counsel to consider recommendations of the depositor.
4. Deposit of securities with protective committee if deemed desirable.
5. Receipt of all income and other distributions on the deposited property and according to the noncash items such treatment as is required by the terms of the indenture.
6. Making of periodic charges to currently distributable funds, disbursement of such charges to itself or to the depositor, and making of distributions to certificate-holders.
7. Exchanging of certificates of one denomination for those of another, and of bearer certificates for registered certificates, and vice versa, according to the terms of the indenture.

8. Conversion of certificates into underlying property and redemption of certificates in cash.
9. Handling of proxies in connection with voting of underlying securities. May attend stockholders' meetings and vote securities.
10. Keeping of proper books of record and account, which are open to inspection by the depositor, by any holders of certificates aggregating a full unit, and by taxing authorities at any reasonable time during business hours.
11. Acceptance of bond and issuance of duplicate certificates in cases of lost, mutilated, or stolen certificates.
12. Making of reports to the depositor and certificate-holders, as prescribed or requested, on various matters, among which may be the following:
 - a) Payments and distributions of any sort received by the custodian on the deposited property.
 - b) Sales of securities and other properties by the custodian.
 - c) Distributions made by the custodian on outstanding certificates.
 - d) Certificates surrendered in exchange for part of the deposited property or cash.
 - e) Summaries of funds and balance sheets, periodically as decided upon. Where separate accounts are kept for each investor, as in investment-contract plans, the balance sheet of each account may be submitted periodically to the depositor or the investment manager.
13. Keeping a copy of the indenture and supplements on file at the principal office of the custodian, which are open to inspection at all times during the usual business hours to any certificate-holder. Sometimes the custodian is required to deliver to a certificate-holder a copy of the indenture and supplements upon request, subject to such rules and regulations and such reasonable charge as it may determine.
14. Liquidation of the deposited property after termination of the indenture and distribution of the proceeds.
15. Holding, after liquidation, of unclaimed monies for holders of certificates or coupons for a certain length of time stated in the indenture.

The compensation which the custodian receives may be divided on the basis of the types of functions for which it is paid. These functions are those of a special nature, usually for the benefit of specific certificate-holders, and those of a general nature for the benefit of the certificate-holders as a group.

The special functions relate to such matters as the exchange of certificates of one denomination for those of another, the replacement

of mutilated, lost, or destroyed certificates, and the registration of certificates. Compensation to the custodian for such services is paid only at the time the service is rendered and is charged to and paid by the particular certificate-holder for whom the service is performed. The fee is based upon the issuance of each new certificate, the charge usually being between \$1.50 and \$2.50 per certificate. This fee is often divided with the depositor in those cases where the depositor provides the new certificate for authentication.

Two principal methods are used in compensating the custodian for its general functions, among which are the checking and retention of deposited property, the collection and distribution of income, the keeping of records, and related matters. The custodian may be paid for its services over the life of the company out of the initial loading charge. In this case the depositor receives the initial loading charge upon the sale of the certificates and remits to the custodian its portion. Or the compensation to the custodian may be in the form of a semi-annual charge payable from currently distributable funds. In some cases a combination of these two methods is found.

CHAPTER V

THE CONTRACTUAL TYPE INVESTMENT COMPANY IN ENGLAND

The most recent development in the contractual investment company field has been the rapid increase in the number and importance of these companies in Great Britain. The first fixed company was organized in Great Britain in 1931. Previous to that time considerable numbers of British investors had purchased participating shares in American fixed companies as a result of the efforts of the American sponsors of the companies to build up sales in England, but the era of the "fixed trust" in the United States in 1930 and early 1931 did not excite much comment in Great Britain. An article in the *London Evening Sun* for November 10, 1935, stated that:

Five years ago the name "fixed trust" was unknown to the general body of investors in this country. Only a few men in the City who had kept closely in touch with financial developments in the United States could have described what a fixed trust was, how it operated, and what was its strength and what its weaknesses.

The movement in England gained headway but slowly at first, only three companies being in existence at the end of 1932. In 1933 and subsequently, however, development occurred more rapidly. In 1935, 21 new companies were formed and in April, 1936, 58 were in existence and actively selling shares. Of these 58, 50 are of the fixed or semifixed type, with a tendency toward the latter type, while 8 are of the restricted management, or, as the British call it, the "flexible management," type.

In many respects the growth of the fixed company in England is a paradox. We have seen in several connections the close relationship between the mistakes of the management type company in this country and the subsequent growth and popularity of the fixed company. The public bought the shares of fixed companies as a result of the "flight from management." The features of the fixed company which most clearly differentiated it from the management company were the

strongest selling points which the sponsors could use. It has appeared that the fixed company became popular in the United States because the American management company did not adhere to the principles of investment-company organization and operation which had been adopted and used consistently by the British management companies. Yet now we find the fixed company immensely popular in Great Britain where the management company has been held in the highest regard in the financial community since 1900. In the United States the management company became unpopular and the fixed company then became popular. In England the management company never lost its popularity, yet the fixed company has now assumed growing importance.

The fixed and semifixed companies had just come into disrepute in the United States at the time the British investing public took over the idea avidly. Common stocks have never been held in as high regard as investments in England as in the United States, yet most of the British fixed companies hold common stocks exclusively in their portfolios. The "small investors" for whom the fixed company was primarily designed have never been numerous in England, yet \$250,000,000 worth of shares (designated in England as "subunits") have been sold to more than 150,000 small investors. The period of rapid growth of the fixed company started in England in 1933, which was a year of intense depression in the United States and in England and a year when common stocks were not regarded highly in either country. A writer in the *Spectator* for June 7, 1935 (p. 974), remarks that it is

. . . striking testimony to the popularity of the fixed trusts that a new idea in investment should have made such headway at a time when the dividends of most of the older trusts had contracted, owing to the general decline in the income from oversea investments in which those trusts found their most remunerative field.

However, the fixed-company movement in England, in contrast to the United States, has been fortunate in that it started its development at a time when trade improvement was just getting under way in England, while yields on gilt-edged securities had fallen to low levels. In a sense the fixed company, indigenous to the United States, has been a characteristic of the current revival in England in the same way that the management company, which began in England, was an im-

portant feature of the 1928-29 prosperity period in the United States. The prices of the British fixed-company subunits are now in almost every case higher than the original offering price as a result of recent advances in stock prices in the British markets. The popularity of the institution is evidenced by the fact that the differences between the buying and selling prices of the subunits in the open market are in many cases considerably less than the initial service charge.

The popularity of the fixed company as an exponent of the theory of common stocks as long-term investments has been aided by certain studies of Mr. H. E. Raynes in England which have produced conclusions similar to those reached by E. L. Smith and others in this country. Mr. Raynes made public the results of his studies in a paper read before the Institute of Actuaries in 1927 entitled "The Place of Ordinary Stocks and Shares in the Investment of Life Assurance Funds." Mr. Raynes made a study of the return over a period from March 31, 1912, to March 31, 1927, of £54,000 invested in ordinary stocks or shares covering nine groups of British enterprises, compared with a similar sum invested in the debenture issues of the same companies. He found that in no year out of the fifteen did the income from the ordinary stocks fall as low as that yielded by the fixed-interest stocks. The market value of the several fixed-interest-bearing groups in 1927 was in every case less than the original group in 1912. Among the ordinary stocks, only three groups showed depreciation, whereas three had more than doubled in value. In the aggregate, the market value of the ordinary shares was nearly double that of the fixed-interest securities. The results of these studies are subject to certain criticisms but they have exerted considerable influence upon the development of the common-stock theory of investment in England.¹

What are the principal differences between the structure and methods of operation of the English fixed companies and those of this country? The English companies have from the first followed a policy of granting discretion to the managements with regard to eliminations. In the first British fixed company to be organized, the First British Fixed Trust, the obligation to eliminate shares from the portfolio was

¹ See the *Manchester Guardian Commercial*, January 27, 1934, p. 63.

definitely permissive. The early British companies granted discretion to the managers to eliminate or not to eliminate upon the occurrence of some specific event. The later companies have simply given absolute discretion to the management to eliminate a security "if it is considered desirable in the interest of the certificate holders," although in some cases the custodian has the right of veto.

"Flexibility" has gradually come to be the keynote of investment policy. Mr. George Glasgow, an English critic of the fixed company, claims that this type has cultivated the alternative epithet "flexible" in place of the term "management." He refers to the fact that the fixed company has been trying to set itself up as the first institution to furnish diversification to the small investor whereas the British management company has been doing that for fifty years. With regard to the use of the terms "management" and "flexible" he characterizes their use as representing the "supreme paradox of a stealer of thunder being driven to restore the thunder."²

A number of companies have adopted the so-called "alternative panel," which is equivalent to the reserve list in the United States. It is quite common to establish at the beginning a rather long list of securities from which the "managers" may choose any or all securities for the portfolio at any particular time, subject to certain limitations as to a minimum number of securities. A few companies have given to the managers the right to introduce a limited number of new securities to replace eliminated securities, thus adopting a policy of permitting substitutions from outside the original list. This is the so-called "open" or "open-end" principle. English writers often designate the change from fixity to semifixity as a shift from negative flexibility (mechanical elimination provisions) to positive flexibility.

The specialized company has been relatively more important in England than in the United States. Particularly have companies with bank shares and insurance shares in their portfolios assumed prominence. The importance of these two industries in English economy probably at least partially accounts for this trend. South African gold-mining shares have also been important components of fixed-company

² George Glasgow, "Fixed Trusts or Investment Trust?" *Fortnightly Review*, February, 1936, p. 141.

portfolios, partly as a result of the high price of gold in England during the past few years.

The sponsors of the English fixed companies are heavily concentrated in London, and partly as a result of this as well as a result of the fact that the number of banking houses is smaller in England, the "trusteeship" of British companies has been more concentrated than in the United States. The Midland Bank Executor and Trustee Company serves as "trustee" for twenty-nine companies, Lloyd's Bank for twelve, the National Provincial Bank for three, William Deacon's Bank and Martin's Bank for two each, and the Clydesdale Bank for one. Three of the "Big Five" act as custodians for forty-four of the fifty-eight companies. Barclay's and Westminster Banks have followed the policy of not accepting any business of this character.

There is considerable evidence that the success of the movement in Great Britain is partially to be accounted for by the public confidence in the British banks which are serving as custodians. This seems to be the case in England to a much greater extent than when the movement in the United States was at its height. Mr. Bird in the article in the *Banker* previously referred to tells the story of the member of a London financial institution who inquired of his broker concerning the merits of a certain fixed company, adding "The certificates yield 5 per cent, which is guaranteed by the bank." A number of commentators in England have pointed out that the investing public may not fully realize the limitations of the trustee's functions, which leads to speculation as to the possible effect on the prestige of the banks acting as custodians if the movement comes to such an ignominious end as in the United States.

It is notable that the English banks are taking a greater interest in the matter than ever did the American trust companies and are insisting on a strict definition of their functions in advertisements and booklets. A number of companies have adopted the term "custodian trustee" which, it will be noted, is a half-way step to the term which is used in this study to designate the bank with which the underlying securities are deposited. The term is intended to convey the fact that the bank's main functions are to undertake the proper issue of certificates and to make distributions to the beneficiaries. The banks which

are acting as custodians, the London Stock Exchange, and the Association of Fixed and Flexible Trust Managers are at present co-operating in an effort to dispel existing misconceptions in the minds of investors as to the functions of the banks.

One complicating feature in the development of the British fixed company has been the existence and purchase for portfolios of part-paid shares. This has led in some cases to the necessity for a provision which would guarantee certificate-holders against assessments because of the part-paid nature of the underlying securities. A number of companies have solved this problem by providing that the managers or the custodian must make provision by insurance or otherwise against uncalled liability or must maintain in the portfolio holdings of British government or other high-grade securities or cash sufficient to cover the entire liability for uncalled capital.

A trend similar to that which has taken place in the United States is seen in the increasing importance of the custodian. The custodian is often given full power to remove the "managers" while the management has no power to remove the custodian.

Most of the British companies are of the capital accumulation rather than the maximum distribution type. "Bonus shares" are generally added to the portfolio. It is noticeable that in the advertising by the British companies several devices are used which were an unfortunate feature of early American fixed-company advertising—namely, the use of "would have been" charts and the advertising of yields which give effect to capital appreciation.

The "spread" is usually stated in terms of a percentage charge per year and ranges from $\frac{1}{6}$ of 1 per cent to $\frac{3}{8}$ of 1 per cent per year on the capital invested. This is paid in the form of an initial loading charge of about 5 to 7 per cent. This charge compares favorably with those existent in American companies. The British companies, however, generally provide for a periodic fee to take care of the continuing expenses of the custodian. The cost of distribution of subunits appears to be lower than in the United States. A writer in the *Statist* for May 5, 1934, complained that it was difficult to understand why the management of a fixed company should pay stock brokers a commission on the sale of subunits of 1 per cent, which was four times the commission

paid when that agency acted as broker in the purchase of the underlying securities on the Exchange. However, the costs of distribution of fixed-company shares in the United States have been between 4 per cent and 6 per cent.

The growth of the fixed company in England has led to the pointing out of a number of possible dangers in the movement by writers on the subject. The one which has received most consideration has been the possibility that such a large percentage of the outstanding stock of a corporation would be acquired by fixed companies that there would be a possibility of breaking the market for the security in case circumstances arose which prompted several of the companies to sell their holdings simultaneously. This possibility was at one time considered important in the case of American companies, but the danger was much exaggerated. In the case of the British companies, however, the danger seems to be more serious, largely because of the smaller number of large British companies whose stock is outstanding in large amounts and the tendency among the British fixed companies to concentrate on a few issues even more than have the American companies. The number of units which may be deposited for a particular series may be limited, but subsequent series may and often do contain the same securities. George Glasgow in an article in the *Fortnightly Review* for February, 1936 (p. 142), points out that 24.8 per cent of the outstanding shares of Allied Ironfounders, £1 ordinary shares, are held by fixed companies, as well as 12.2 per cent of the £1 ordinary shares of Imperial Continental Gas and 31.7 per cent of Amalgamated Press 10s ordinary shares. The figures are indeed startling when it is considered that not over 10 per cent of the outstanding shares of any American corporation were ever held in the portfolios of fixed investment companies in this country.

It is probable, however, that some of the dangers in connection with the markets for the underlying securities in fixed companies have been exaggerated. Particularly is this true of a writer in the *Spectator* for June 7, 1935 (p. 994), who suggested that a disturbance in markets might result from a big rush of subscribers to a fixed-company issue in that the broker who was purchasing the underlying securities for this company might be at a disadvantage because the prices of the securities might be set against him. The number of fixed companies now in

existence precludes the possibility of any such rush to one issue. In fairness to the writer, however, it should be remarked that he concluded this article with the statement that there was no evidence so far to suggest that the operations of fixed companies had been responsible for driving up the prices of such shares, since the shares which appear most often in portfolios had not risen in price disproportionately to the general list of high-class securities of similar type.

One principle which has been important in the development of the management company in Great Britain has also been adopted by the fixed company—namely, the principle of wide geographical diversification. However, such diversification has not been an important characteristic of the portfolios of individual fixed companies, but has rather evidenced itself in the organization of a number of companies holding shares originating in parts of the world remote from England, although companies operating in the British dominions have been the most prominent in portfolios.

Another characteristic which the British fixed company seems to have evolved without any help from this country is an emphasis upon large-scale diversification. A number of companies has been organized holding portfolios of from 100 to 150 securities. One of the companies sponsored and “managed” by Fixed Trust Investments, Ltd., consists of 150 of the “leading industrial and financial companies of the Empire” and is designated British Empire Comprehensive Fixed Trust Certificates.

The British companies in making up their portfolios have placed far greater emphasis upon preference shares than have American companies. This is partially due to the greater use of preference shares in corporate financing in England. As a result of this tendency, British fixed companies have in their literature stressed the income feature to a greater extent than appreciation. The percentage of the value of preference shares to the total value of the unit in many of the more recently organized companies ranges from 25 to 50 per cent. The criticism has been offered that the presence of prior securities offsets to some extent the prospective capital appreciation which the investor has been led to expect.

The fixed companies have come in for their share of criticism and demands for regulation. A criticism of the institution was voiced by a

member of the House of Commons in that body as far back as February 15, 1934. His criticisms, it is reported, were answered by Mr. Neville Chamberlain to the effect that the public could best protect itself by declining to invest in any fixed company which was not under the control of trustees of the highest repute. The movement finally led to an investigation by a subcommittee of the London Stock Exchange which issued its report on December 12, 1935. It was published in the press on January 3, 1936. Like the report of the New York Stock Exchange in 1931, it surveyed the possibilities for abuse and fraud in the fixed-company movement, but unlike the report of the American exchange, it recommended legislation to deal with the problem. The subcommittee report stated in this connection:

It cannot, however, be overlooked that such Regulations, if established by the Stock Exchange alone, would extend no further than the exclusion from the Market of the Stock Exchange of those Trusts which do not comply, and from the services of members of the Stock Exchange as brokers in connection with dealings in units and sub-units. The Regulations afford no means of controlling the activities of any trust which is content to find its own market elsewhere, and there is, in fact, considerable ground for saying that the majority of fixed trust managers would welcome conditions which constituted them the sole market for their own sub-units. . . .

The ultimate conclusion of the sub-committee is, therefore, that the full measurement of protection to which the public is entitled can only be achieved by legislation which can be universally enforced, and that such legislation lies outside the scope of the authority of the Stock Exchange itself.³

The report further pointed out that promoters of fixed companies are not bound by most of the sanctions that apply to concerns intrusted with capital publicly subscribed and that there were potential temptations to the managers to take the initial service charge in a lump sum in advance of the twenty-year period for which, in theory, the charge constitutes its remuneration. A number of companies have avoided this objection by depositing the entire service charge with the custodian under a contract by which only a certain proportionate amount is paid

³ George Glasgow, "Fixed Trusts or Investment Trusts?" *Fortnightly Review*, February, 1936, p. 144.

to the managers each year for management services. If the managers go out of business, the custodian is authorized to appoint new managers.

Partially as a result of the subcommittee's report an Association of Fixed Trust Managers, more recently the Association of Fixed and Flexible Trust Managers, has been formed, membership in which is confined to such companies as conform to the principles enumerated in the Stock Exchange subcommittee's draft regulations, pending any legislation that may be enacted. Membership in the Association of Fixed and Flexible Trust Managers is thus equivalent to being placed on the "unobjectionable" list by the New York Stock Exchange in 1931. At the time of formation of the Association all but two of the eleven large sponsoring groups became members.

